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June 26, 2003

Mr. Ernest Johnson
Director, Utilities Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007-2996

RE: Docket No. E-01345A-02-0707

Dear Mr. Johnson:

In Docket No. E-01354A-02-0707, which was Arizona Public Service Company's ("APS" or "Company") Application for Financing Authority, the Arizona Corporation Commission's Utilities Division Staff requested through its counsel that APS prepare a report in advance of the preliminary inquiry that Staff was to commence pursuant to Decision No. 65796 (April 4, 2003).

Subsequently, counsel for the Company and counsel for Staff met to discuss the timing for the completion of such report. As agreed to by counsel for Staff and the Company, APS provided Staff with the Company's report on June 13, 2003.

Staff has requested that APS also file the report in the referenced docket. Accordingly, APS is docketing the report with this transmittal letter and providing copies to all parties of record for informational purposes only. The Company is not requesting that any Commission action be taken on this filing.

If you or your staff have any questions, please don't hesitate to call me.

Sincerely,

Jana Van Ness
Manager
Regulatory Compliance

Encl.

cc: Christopher Kempley, Esq.
Parties of Record
Docket Control (Original + 13)

Arizona Public Service Company's
Report to the Arizona Corporation Commission

June 13, 2003

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I. EXECUTIVE SUMMARY

This Report to the Arizona Corporation Commission ("Commission") has been prepared in response to Decision No. 65796 (April 4, 2003). That decision directed the Commission's Utilities Division Staff to commence a "preliminary inquiry into APS' and its affiliates' compliance with the Electric Competition Rules, Decision No. 61973, APS' Code of Conduct, and applicable law." Each of these issues is addressed in this Report. In addition, APS will respond to certain specific assertions made during the January 2003 hearing on APS' Financing Application. This Report demonstrates that:

- APS and its affiliates have, within the regulatory constraints placed upon them, consistently acted in the best interests of APS customers and took reasonable and prudent steps to protect those interests.

- As a result of these actions, APS successfully weathered a storm that engulfed virtually every other investor-owned utility in the Western United States without having to threaten bankruptcy, request emergency rate relief, defer significant purchased power costs, institute capacity-related curtailments, or be forced into high-priced, long-term purchase power agreements.

- During a period of significant change and substantial uncertainty in the electric utility industry, APS and its affiliates acted ethically and appropriately to comply with regulatory requirements relating to restructuring in Arizona. In many respects, APS and its affiliates went far beyond mere technical compliance and instead acted aggressively to protect customers in instances where the Electric Competition Rules provided little guidance.

- APS has neither surrendered nor neglected its obligation to serve customers. Because APS has not and will not entrust that obligation to others, it is well-positioned to *continue* to provide reliable, reasonably-priced service to Arizona consumers.

- Although APS participated vigorously in the debate surrounding the various state and federal efforts to restructure the electric industry, once the responsible state or federal regulatory authority set its restructuring policies, APS was a leader in implementing both their letter and spirit.

- When contemplated APS actions on behalf of customers required regulatory approval or a variance to a Commission rule, APS requested relief from the Commission in an open and legally appropriate manner.

- Despite the changes made by the Commission to the 1999 Settlement, APS continues to comply with its obligations under that Agreement and to work toward reasonable regulatory solutions to address the impacts on itself and its affiliates of the changed circumstances that both precipitated and resulted from those changes.

Regarding specific questions that arose during the proceedings on the APS Financing Application, APS' and its affiliates' actions were entirely lawful and reasonable and protected both APS customers and investors. This Report explains that:

- Pinnacle West Energy Corporation ("PWEC") was formed to implement the Commission's requirement that incumbent utilities divest their generation. Its formation was not only specifically authorized by the Commission in Decision No. 61973 as being in the public interest, but the Commission expressly stated that it *supported* the transfer of *all* of APS' generation to an affiliate. The Commission also acknowledged in the 1999 Settlement that sales between APS and its generation affiliate at market based rates would benefit customers, would not violate Arizona law, would not provide APS' affiliate with an unfair competitive advantage, and were in the public interest. Subsequent to PWEC's formation, the Commission was informed on several occasions that PWEC generation was going to be used, and even relied upon, to serve APS customers.

- Because the Electric Competition Rules prevented APS from constructing new generation, PWEC and its parent company, Pinnacle West Capital Corporation ("Pinnacle West"), took action to protect APS during the turmoil of the Western power crisis in 2000 and 2001. PWEC both brought in temporary generation to allow APS to meet short-term summer capacity needs driven by rapid load growth, and constructed permanent capacity to provide a long-term resource for APS customers.

- By dedicating its capacity to APS customers and not selling forward into the lucrative California markets, PWEC prevented APS from falling victim to the rush into high-priced, long-term contracts that occurred in California, Nevada and elsewhere during the height of the Western power crisis. Unlike utilities in other states, APS knew that capacity would be available for its customers at reasonable prices. PWEC's actions in no small part allowed APS to continue providing the rate reductions as provided for in the 1999 Settlement while other utilities throughout the West sought significant rate increases.

- Because PWEC was entitled to receive *all* of the APS generation under the 1999 Settlement, the receipt of such generation and its subsequent operation by PWEC after 2002 was a valid and reasonable business assumption—indeed, the only valid and reasonable business assumption—for PWEC to have presented to rating agencies in requesting a contingent credit rating. Further, the assumptions presented to those rating agencies to support their modeling were based on assumed sales at market prices. Thus, the results were indifferent as to whether PWEC had a contract with APS at market prices or simply sold to a third-party at the same market prices. There was no representation made to the rating agencies that PWEC actually had a signed multi-year contract with APS or was entitled to receive a multi-year contract except in conformance with the Electric Competition Rules.

- APS never entered into any supply agreement that violated Rule 1606(B), which was not to take effect for APS until January 1, 2003. In fact, during its 2001 *request* to the Commission for a partial variance to that rule, APS specifically confirmed that if the Commission denied the requested variance, APS would proceed with "good faith compliance with Rule 1606(B) as written."

- The APS Code of Conduct contained, as required by the 1999 Settlement, a provision relating to the supply of APS generation during the two-year delay of divestiture to ensure that APS' Competitive Electric Affiliate, APS Energy Services ("APSES"), was not given an unfair competitive advantage. In the decision approving APS' Code of Conduct, the Commission specifically found that the Code of Conduct jointly proposed by Staff and APS "satisfies the requirements of A.A.C. R14-2-1616 and Decision No. 61973." APS has complied with that provision.

- As required by applicable regulations, APS applied for the modifications required to be made to the air permits for the PWEC West Phoenix and Saguaro Power Plant units because these new units were under common corporate control with the existing APS units. In a similar fashion, APS holds the air permit for other jointly-owned facilities that do not involve an APS affiliate.

Electric Competition Checklist

1	Opened service area to competition	☑
2	Dismissed court appeals to Electric Competition Rules	☑
3	Reduced rates by more than $400 million	☑
4	Resolved stranded costs	☑
5	Assured reliable electric service to customers	☑
6	Corporate restructuring to comply with the rules	☑
7	Developed systems and processes to support direct access	☑
8	Filed direct access rates	☑
9	Supported AISA protocols	☑
10	Developed WestConnect RTO	☑
11	Adopted retail Code of Conduct	☑
12	Timely filed adjustment clause application	☑
13	Filed all required reports	☑
14	Formed APSES as competitive ESP affiliate	☑
15	Provided nondiscriminatory open access to transmission and distribution systems	☑
16	Met Provider of Last Resort obligations	☑
17	Divested generation to PWEC	Suspended
18	Implemented Rule 1606(B)	Suspended
19	Implemented new Track B requirements	☑

This Report includes a discussion of historical background and regional context. It is impossible to fully consider the events of the last several years, since the execution of the 1999 Settlement and the adoption of the current Electric Competition Rules, without a detailed understanding of this background. It also is necessary to consider the significant changes and the

increasing uncertainty in both state and regional electric markets over this period, and to view the actions of APS and its affiliates in that context.

When the initial Electric Competition Rules were passed and the 1999 Settlement signed, many believed that retail Electric Service Providers ("ESPs") would sweep into the state and take significant amounts of load from incumbent utilities. Little attention was paid to wholesale power markets, which in 1999 were still relatively stable and, like today, largely subject to exclusive federal jurisdiction. In fact, no independent power producer apart from Enron, which also was an ESP, participated in the 1999 Settlement proceeding.

Despite a requirement that APS divest all of its generation to facilitate the development of the retail marketplace, and despite the lack of clear "rules of the road" from the Commission regarding how APS could operate, the Commission still expected the Company to take the steps necessary to serve all present and future customers. Moreover, APS was expected to do so reliably and at just and reasonable rates. Further, following the 1999 Settlement, APS implemented a series of rate reductions and, absent an emergency, could not increase rates even if its costs rose unexpectedly. In 1999, however, APS needed to purchase increasing amounts of power from the wholesale market and its peak demand was growing rapidly. Fortunately for APS customers, over the next few years, the actions taken by APS and its affiliates and the actions taken in neighboring states like California stand in stark contrast.

In California, investor-owned utilities divested their generation to non-affiliates and the utilities and the California commission lost control over those resources. In California, generation shortages caused rolling blackouts throughout the state. And in California, the shock of two summers caused all three major investor-owned electric utilities to defer billions of dollars of wholesale power costs, impose major rate increases, and ultimately forced the California Department of Water Resources ("CDWR") to take over generation procurement. One utility is still in bankruptcy and all have been financially ravaged in the credit markets. Finally, in California, CDWR entered into high-priced, long-term wholesale power contracts that were significantly above the cost of generation in an effort to stabilize the chaos that had rocked the state. California is now litigating and attempting to abrogate those contracts, causing increased turmoil in energy capital markets.

On the other hand, in Arizona, APS negotiated with the Commission to ensure that divestiture would take place only to an affiliate of APS. Ultimately, the Commission stopped divestiture altogether. And in Arizona, PWEC installed expensive temporary summer capacity and constructed new generation resources to meet the needs of APS customers. Not coincidentally, the lights in Arizona stayed on. While rates elsewhere spiraled out of control, APS passed on to customers the rate reductions that it had agreed to without deferring any wholesale power costs and still retains its investment grade credit ratings. This was due in no small part to the fact that in Arizona, the construction of new generation by PWEC eliminated the panicked buying of long-term contracts because APS knew that capacity would be available for its customers.[1]

[1] The history of the steps that APS and PWEC reasonably took to ensure that APS customers were not subjected to the vagaries of a dysfunctional wholesale power market will be explained in greater detail in the rate case that APS will file with the Commission.

In retrospect, the robustness of wholesale power markets was more important in the overall process of electric restructuring than many had envisioned. While California has essentially stalled retail competition and is considering an aggressive return to a more traditional utility model, Arizona has not suffered such a result. But the uncertainty for incumbent utilities in Arizona continues. There now exists a mix of vertically-integrated utilities with a "Track B" requirement to seek some power supplies for an undefined period of time from the wholesale market (even when APS' supplies are sufficient) and with the continuing risk that retail load will leave for direct access service. But the prudent actions of APS and its affiliates during this period have at least left the Commission and the state with significant flexibility as to where Arizona moves in the future with electric competition.

II. INTRODUCTION AND SCOPE

A. Introduction

Decision No. 65796 (April 4, 2003), which approved APS' Financing Application, directed Staff to commence a preliminary inquiry into APS' and its affiliates' compliance with:

- the Electric Competition Rules;
- Decision No. 61973;
- APS' Code of Conduct; and
- applicable law.

This Report addresses each of these issues, while providing background and context that the Company believes is important to consider on each of these issues. This Report also responds specifically to some of the assertions that were made during the hearing on APS' Financing Application in Docket No. E-01345A-02-0707.

B. Organization of Report

Section I of the Report is an Executive Summary. Section II provides an introduction to the Report, defines the scope of issues addressed pursuant to Decision No. 65796, and sets forth certain definitions and concepts that will be used throughout the report.

Section III provides a relatively extensive factual and historical background of APS' and its affiliates' role and involvement in the restructuring of the electric power industry in Arizona. This background discussion also addresses events outside Arizona that have had a significant effect on the Company and its affiliates due to the regional nature of the Western electricity grid.

Section IV discusses each of the categories of issues identified in Decision No. 65796, including a discussion of "applicable law." Section V then responds specifically to certain issues raised during the hearings on APS' Financing Application earlier this year. Section VI is a conclusion. Finally, a Glossary of Terms is provided at the end of this Report.

C. Scope of Report

Decision No. 65796 sets forth the scope for this Report. Pursuant to that decision, this Report addresses (i) APS' and its affiliates' compliance in Arizona with the Electric Competition Rules, A.A.C. R14-2-1601 to -1617; (ii) Decision No. 61973, which approved the 1999 Settlement; (iii) APS' Code of Conduct, which was approved in Decision No. 62416; and (iv) applicable law.

This Report also addresses specific matters referred to in Decision No. 65796 and discusses the steps that APS took to respond to Commission orders and decisions and to comply with the Electric Competition Rules. These include the corporate restructurings undertaken to satisfy requirements in the Electric Competition Rules. They also include the significant steps that APS undertook to implement retail direct access in Arizona, and APS' efforts to further the

development of wholesale markets from which the Company will continue to be a significant buyer. Most importantly, however, this Report demonstrates the steps APS took to meet a rapidly growing customer load during a period of extreme volatility in wholesale power markets while managing both risk and cost.

Because the issues that Decision No. 65796 directed Staff to evaluate are Arizona issues, this Report focuses primarily on Arizona and Arizona law. Where applicable, however, this report discusses regional or national issues as well to provide necessary context.[2] Similarly, most of the matters raised in APS' Financing Application hearing occurred over the last three to four years. To fully capture the evolution of the Electric Competition Rules, however, this Report also addresses some developments that occurred prior to 1999.

D. Definitions and Concepts

For purposes of this Report, an understanding of certain definitions and concepts is necessary. First, the term "affiliates" when used in this report refers, unless otherwise noted, to those APS' affiliates involved in the electric utility industry in Arizona. Thus, the term includes Pinnacle West, which is the parent entity in the holding company structure; PWEC, which is the wholesale generation affiliate; and APSES, which is a retail Electric Service Provider pursuant to A.A.C. R14-2-1601(15).[3]

Second, APS has interpreted the term "applicable law" broadly to refer to the specific Commission orders discussed above, applicable federal and state antitrust laws and regulations, Arizona laws and regulations relating to utilities and electric competition, applicable regulations of the Federal Energy Regulatory Commission ("FERC") and the Securities and Exchange Commission ("SEC"), and the Federal Power Act, where applicable.

Third, the term "APS Code of Conduct" refers to the retail Code of Conduct approved in Decision No. 62416 (April 3, 2000).

Fourth, the term "Electric Competition Rules" is defined to include R14-2-1601 to R14-2-1617, which are the principal rules directed toward retail electric competition. APS has not for purposes of this Report included specific discussions of the various amendments that were made to R14-2-201, *et seq.*, during the rulemakings, nor has it included a discussion of the

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[2] Given the scope identified in Decision No. 65796, this Report does not cover actions of APS and its affiliates outside of Arizona. For example, APSES has received a certificate from the California Public Utility Commission and has been significantly involved in direct access issues in that state. It also provides services in California, as well as Texas, Nevada, and other states. Similarly, PWEC is constructing a power plant in Nevada, which has certain regulatory requirements not relevant to this Report.

[3] Because the issues addressed in this Report relate to electricity regulation, the term "affiliates" does not include SunCor Development Company, which is a Pinnacle West real estate subsidiary, or El Dorado Investment Company, which is Pinnacle West's venture capital subsidiary, or their respective subsidiaries. NAC Holding Inc. is a subsidiary of El Dorado based in Atlanta, Georgia that manufactures dry cask storage for the nuclear industry. Given the narrow business focus of NAC, it is not considered an electric industry affiliate for purposes of this Report.

Environmental Portfolio Standard found in Rule R14-2-1618, which is not directly related to retail electric competition.

III. BACKGROUND AND CONTEXT

A. Development of the Electric Competition Rules

Many states, including Arizona, began to consider retail electric competition after the California Public Utilities Commission published its "Blue Book" report in 1994. The Commission first opened an investigation on retail electric competition in 1994, and the first phase of the investigation concluded in 1995. In early 1996, Staff requested comments from interested parties to help develop the first set of electric competition rules.

That request for comments articulated the original Staff and Commission view of the appropriate goals for retail electric competition. One central goal was to encourage the hoped-for benefits of retail competition, "including increased innovation and efficiency, holding prices down, responsiveness to customer demands, and customer choice among suppliers and products."[4] Additionally, however, the Commission's original goals recognized that retail electric competition should "limit potential harm to utilities and utility investors" and not adversely affect system reliability.[5] Also, customers who would not or could not participate in the competitive market were to be protected from rate increases attributable to competition.

All of the goals articulated in 1996 were focused on *retail* competition. Thus, the Commission's Staff noted that market impediments "such as the exertion of retail market power by incumbent utilities which blunts competitive forces and high retail transaction costs for market participants" should be avoided.[6] The focus was on developing a vibrant retail market and encouraging a variety of retail market developments, including ESP contract development, ESP interconnection arrangements, spot market development and retail rate unbundling.[7]

By mid-1996, the Commission issued its first proposed electric competition rules. After numerous public meetings and volumes of written comments, rules were adopted by the Commission in Decision No. 59943 (December 26, 1996). As originally enacted, the electric competition rules did not contain many of the provisions that some parties have since claimed are "cornerstones" of restructuring. For example, there was no required separation of competitive and non-competitive electric services, no code of conduct requirement, no competitive bidding requirement and no divestiture requirement. Under these 1996 rules, retail open access was to begin in phases starting in 1999.

The 1996 electric competition rules were challenged by virtually all of the incumbent electric public service corporations, including APS. The challenges included claims that it was unlawful to amend the noncompetitive Certificates of Convenience and Necessity ("CC&Ns") of incumbent utilities to permit competition, that the rules constituted an impairment of contract and were a regulatory taking of private property, that the rules violated principles of due process and equal protection, and other procedural and substantive claims. No merchant generator or competitive retail ESP challenged the 1996 rules, however, even though the rules did not address

4 February 22, 1996 letter from Utilities Division Director Gary Yaquinto to interested parties.

5 *Id.*

6 *Id.*

7 *Id.*

the "cornerstone" issues listed above. The 1996 electric competition rules remained in place until 1998, when the Commission decided to reopen them.

In mid-1998, a new set of electric competition rules was proposed and adopted on an interim basis in Decision No. 61071 (August 10, 1998). These new rules, which were finalized on a "permanent" basis when rehearing applications were denied on December 31, 1998, added the mandatory divestiture requirement for the first time, but still made no mention of competitive bidding for Standard Offer load. The rules also eliminated the Solar Portfolio Standard, which was the predecessor of the current Environmental Portfolio Standard. The 1998 electric competition rules lasted only six days, however, before they were stayed by the Commission pending yet another rulemaking process.

In 1998, the Commission first focused on divestiture as a necessary component to its vision of retail competition. Despite the objections of the utilities to this concept in general, the debate centered on whether the divestiture should be to a third party, should be conducted through an auction, or whether utilities should be allowed to divest to affiliates.[8] In late 1998, the Executive Secretary of the Commission, with Staff acting as a party in negotiations, brokered a settlement of these and other contentious electric competition issues involving APS and Tucson Electric Power Company ("TEP"). Under the 1998 Settlement, APS would be permitted to retain its generation despite the new electric competition rules—and even acquire some of TEP's generation—but would divest most of its high voltage transmission system to TEP. Neither utility would have to write-off any stranded costs. The 1998 APS-TEP-Staff settlement was appealed to the courts by the Arizona Attorney General's Office and other intervenors before the Commission could even hear it. After Commission hearings on the settlement were stayed, the settlement was withdrawn.

Also in 1998, the Legislature enacted House Bill 2663 ("H.B. 2663") regarding retail electric competition. This legislation confirmed the authority of the Commission to adopt various provisions of the Retail Electric Competition rules, to the extent such confirmation was necessary. It also included provisions to address electric competition for certain defined Public Power Entities, primarily Salt River Project, which were not subject to the Commission's jurisdiction. The Legislature's directives for electric competition involving Public Power Entities, however, were significantly different in certain key respects from the Commission's Electric Competition Rules, both in 1998 and as later modified. For example, H.B. 2663 did not require divestiture of generation by Public Power Entities nor did it address wholesale procurement by Public Power Entities in any respect. These differences would lead to even more difficulty in smoothly implementing the policy in Arizona.

The next rulemaking process before the Commission culminated in essentially the current version of the Electric Competition Rules. First proposed in April 1999, these rules were adopted

[8] For example, in its original comments on the rules, APS wrote that it "does not believe that divestiture is necessary or desireable" and that mandatory divestiture was beyond the Commission's legal authority and should be left to the discretion of the individual utility's management. *See* APS' Response to Staff's Questions on Restructuring (June 28, 1996) at iv. Later, in response to Decision No. 60977 (June 22, 1998) regarding stranded cost recovery, APS again challenged the Commission's authority to compel divestiture. *See* APS' Application for Rehearing (July 10, 1998) at 4-6.

in Decision No. 61969 (September 29, 1999). As originally proposed, there still was no competitive bidding requirement for Standard Offer load. In fact, the Concise Explanatory Statement that accompanied the approved rules as required by the Arizona Administrative Procedures Act still specifically rejects competitive bidding:

> Analysis: There appears to be some confusion concerning the meaning of the term "open market." We do not wish to impose constraints on energy procurement that would be associated with a competitive bid process. Consequently, we will modify Section 1606(B) to clarify the term "open market." Our clarification is not substantive.[9]

The resolution set forth in the Concise Explanatory Statement was simply to require that Standard Offer power be acquired, after divestiture, in "an open, fair and arm's-length transaction with prudent management of market risks, including management of price fluctuations." Ultimately, however, language on competitive bidding was added to Rule 1606(B) during the Commission's Open Meeting deliberations—primarily at the urging of Enron and Commonwealth Energy, two ESPs that were involved in the rulemaking but who are no longer conducting business in Arizona.[10]

Despite the amendment to the rule during the open meeting, two aspects of Rule 1606(B) still seemed clear with respect to competitive bidding. First, the rule was premised on the fact that the Utility Distribution Company would not itself own *any* generation and would have to acquire all of its generation supplies from the wholesale market. And, second, there was a clear concern about risk management and protecting Standard Offer customers from significant price volatility.

B. The 1999 APS Settlement Agreement

Also in 1999, the Commission asked APS and TEP to meet with affected customer groups and try to negotiate new settlement agreements having more broad-based support than the 1998 settlement. APS commenced negotiations with all of its major customer groups, with the Commission Staff participating as an observer.[11] On May 14, 1999, APS and all of its major consumer groups filed the 1999 Settlement with the Commission.

The 1999 Settlement called for numerous concessions from APS. Although in both the Electric Competition Rules and Decision No. 60977 (June 22, 1998) (the "Generic Stranded

[9] Decision No. 61969 (September 29, 1999) at App. B, pp. 27-28.

[10] The addition of the competitive bidding language was done without any cost-benefit analysis or economic impact analysis.

[11] Parties to those negotiations, and ultimately the settlement, included a broad cross-section of APS customers, including the Residential Utility Consumers Office ("RUCO"), the Arizona Community Action Association and the Arizonans for Electric Choice and Competition ("AECC"), which is a coalition of companies and associations that support competition. Most of the members of AECC are APS customers. Many other interested parties participated in the proceedings before the Commission on the 1999 Settlement.

Costs Order"), the Commission had assured incumbent utilities of *full* stranded cost recovery, APS agreed to a $234 million write-off of prudently incurred costs and to a series of five rate reductions for both Standard Offer and direct access customers. APS also agreed, absent emergency circumstances, not to seek any rate increases prior to mid-2004 and to forego recovery of any increased purchased power costs incurred until after mid-2004.

In return, Pinnacle West, but not APS, received a partial waiver of some substantive Affiliate Interest Rules (A.A.C. R14-2-801 to -806). Both Pinnacle West and APS received partial waivers of some non-substantive reporting requirements in these rules. Also, APS was assured that it could divest its generation assets to a newly-created Pinnacle West subsidiary, PWEC. This was a significant issue for APS, because it allowed APS' generation to remain under common corporate control post-divestiture rather than having third-parties with potentially no ties to Arizona take over that generation. The experience of California, which required divestiture of much of the state's generation to third parties, bears out the wisdom of that approach.

Significantly, the Settlement also provided that APS' new generation affiliate would not be subject to regulations beyond those applying to any other owner of generation in Arizona, and could sell at market based rates to APS. In approving the Settlement, the Commission expressly stated that it *supported* the transfer of *all* of APS' generation to an affiliate.[12] The Commission also acknowledged in the 1999 Settlement that sales between APS and its generation affiliate at market based rates would benefit customers, would not violate Arizona law, would not provide APS' affiliate with an unfair competitive advantage, and were in the public interest.[13]

The 1999 Settlement was approved by the Commission in Decision No. 61973 (October 6, 1999). On November 24, 1999 an addendum to the Settlement was executed to address changes made during the open meeting at which the Settlement was approved. Specifically, despite assurances in Decision No. 60977 that APS would receive full recovery of the significant costs of asset divestiture, APS agreed to give up a third of such recovery. Also, APS agreed to implement a code of conduct that was more restrictive than required under the Electric Competition Rules.

The 1999 Settlement was later upheld as lawful and binding on all parties and the Commission by the Arizona Court of Appeals in actions brought both by Enron and the Arizona Consumers Council. During the pendency of that litigation, APS wrote-off $234 million of what the Commission had already determined to be prudently-incurred costs. APS also decreased its rates in 1999, 2000, 2001, and 2002. This July, APS will reduce rates yet again, even though other aspects of the 1999 Settlement were changed by the Commission. These rate reductions will result in cumulative savings to customers of more than $400 million through June 30, 2004. And, as will be discussed in more detail below, APS has spent literally millions of additional dollars and thousands of man-hours to comply with the Electric Competition Rules, including the divestiture requirement that ultimately was repealed by the Commission.

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12 Decision No. 61973 at 10.

13 *See id.* at Attachment 1, Section 4.4.

C. The APS Code of Conduct

As required by Decision No. 61973, APS submitted an initial proposed code of conduct on October 28, 1999. This retail code of conduct was in addition to the Company's FERC Code of Conduct that applies to wholesale functions involving APS and its affiliates. APS submitted a final proposed code of conduct on January 5, 2000 after receiving and considering comments from Staff and other interested parties. The nine implementing Policies and Procedures were filed with the Commission on January 12, 2000.

In response to both the original filing by APS and the final proposed code of conduct filed by APS in January 2000, Commission Staff filed an alternative proposed code of conduct with the testimony of its expert witness, Gretchen McClain. Although APS, Staff and other interested parties disagreed on certain issues, APS and Staff ultimately reached agreement on modifications to the Staff proposed Code of Conduct. APS and Staff filed a Stipulation and a Joint Proposed Code of Conduct reflecting that agreement.

In Decision No. 62416, the Commission adopted the Joint Proposed Code of Conduct with certain modifications, clearly noting that the Code of Conduct applied "to the conduct of APS and its competitive electric retail affiliates."[14] In that decision, the Commission concluded as a matter of law that the Code of Conduct complied with the requirements of Rule 1616 and Decision No. 61973. That Code of Conduct, and the associated Policies and Procedures, remain in effect today.[15]

The APS Code of Conduct addressed each of the nine subjects specified in Rule R-14-2-1616, with particular emphasis on such core issues as cross-subsidization by APS customers and anti-competitive discrimination. The Policies and Procedures implementing the APS Code of Conduct address the following issues:

- affiliate accounting policies;
- access to information;
- compliance;
- contracting for personnel services between APS and its Competitive Retail Electric Affiliates;
- ESP contracts and requests for service;

[14] Decision No. 62416 at 5. APS' only Competitive Electric Retail Affiliate was, and still is, APSES.

[15] For purposes of this Compliance Report, the Code of Conduct approved by the Commission in Decision No. 62416 is referred to as the "APS Code of Conduct." As required in Decision No. 65154, APS filed a new proposed Code of Conduct with the Commission on November 12, 2002 (the "Proposed Code of Conduct"). The Proposed Code of Conduct would apply to APS and its interactions with its Competitive Electric Affiliates, which is defined in the Proposed Code of Conduct to include both APSES and PWEC. A hearing is anticipated later this year on the Proposed Code of Conduct after Staff completes its review of the Track B implementation.

- joint promotion, sales, and advertising with a Competitive Retail Electric Affiliate;
- physical separation of entities;
- shared officers and directors; and
- training.

Throughout the entire process of developing the APS Code of Conduct, the focus of the Commission, Staff, and the intervenors was on protecting *retail* competition and ensuring that APS did not unduly favor APSES.[16] There was no discussion of APS' purchases of power from the wholesale market and no merchant generators other than Enron intervened in the proceeding. Enron's principal comments on APS generation focused on the supply of excess generation by APS.[17] That may have been because the parties understood that the FERC Standards of Conduct and FERC Code of Conduct would address APS' relationships with any affiliate that engaged in wholesale power sales, such as PWEC.[18] It also was clear throughout APS' testimony that APS would not be providing competitive services, including Interim Competitive Services, but that such competitive services would "be provided only through a separate competitive affiliate."[19]

D. Implementation of the Electric Competition Rules

APS and its affiliates have worked closely with the Commission, Staff and other stakeholders to implement the Electric Competition Rules since they were first adopted in 1996. Implementation has taken many forms, from broad corporate restructuring to the far more specific processes of developing computer systems and software to transfer data between the Company and ESPs serving direct access customers. In very general terms, the implementation efforts of APS are discussed below.

Corporate Restructuring

The foremost and, in many respects, longest lead-time issue in complying with the Electric Competition Rules involved the corporate restructuring efforts undertaken by APS and Pinnacle West. As a result of the Commission's rules and decisions, APS and its affiliates have undertaken the following corporate restructuring actions since 1999:

- The implementation of a corporate restructuring to accommodate the Electric Competition Rules and implement direct access, including the movement of shared corporate support services to Pinnacle West.

[16] *See* Rebuttal Test. of Gretchen McClain on behalf of The Arizona Corporation Commission, Docket Nos. Docket No. E-01345A-98-0473, E-01345-97-0773 &RE-00000C-94-0165 (January 18, 2000) at 5.

[17] See the discussion of Supply of Generation below at Section IV(B).

[18] See the discussion of FERC Code of Conduct below at Section IV(D)(1).

[19] Direct Test. of Jack E. Davis on behalf of APS, Docket Nos. E-01345A-98-0473, E-01345-97-0773 &RE-00000C-94-0165 (January 21, 2000) at 14-15; *see also* APS Response to First Set of Data Requests, Question 4 (January 14, 2000).

- The formation of APSES, a retail ESP and energy services company, to offer Competitive Electric Services separately from APS.
- The formation of PWEC to receive APS' generation assets following the Commission-required divestiture of such generation at the end of 2002 and to construct any generation assets needed to reliably serve customers.
- The implementation of a multi-year process to result in the transfer, as required by the Electric Competition Rules, of APS' generation to PWEC. This involved significant cost and effort in preparing an application for FERC approval of the transfer; preparing a Nuclear Regulatory Commission application for license transfer authority; negotiations with co-owners, lenders and deed-holders; preparing permit transfer applications; and undertaking numerous other transactional matters relating to divestiture.
- The reshaping of APS as a "wires only" Utility Distribution Company, as then contemplated by the Electric Competition Rules, with a focus on attempting to provide reliable Standard Offer service solely through purchased power, and unbundled distribution service to all retail customers within its service area.
- The formation of a power marketing organization at Pinnacle West to comply with the structural separation requirements of the Electric Competition Rules.
- Active participation in the formation of WestConnect, to which APS would transfer operational control of transmission.
- The implementation of another corporate restructuring plan after the Commission changed course on divestiture and ordered APS to retain its generation, including the transfer of power marketing operations back to APS.

Process Standardization Working Group Participation

Since 1999, APS has taken a leading role in laying the groundwork for retail direct access in Arizona. It has been an active participant in the Process Standardization Working Group, which was established to streamline technical implementation of the Electric Competition Rules by addressing matters relating to such things as billing, metering standards, data interchange, meter reading protocols and certain policy issues. Since that group was formed, almost 150 discrete issues have been identified, most of which have been resolved through collaborative efforts.

Internal Systems and Process Development

APS has expended significant resources to develop internal practices for retail direct access and to acquire the necessary systems and hardware to comply with the Electric Competition Rules. These implementation activities include:

- Active participation at every stage of each of the rulemaking proceedings, investigative dockets, and generic dockets to consider issues relating to retail electric competition.

- The creation and development of electronic systems to support direct access. This involved an investment of more than $20 million in technology, including the creation of a secure virtual private network, new billing software and systems, an electronic data interchange system and associated protocols, training, and personnel for all parties involved.
- The development of procedures and practices for generation settlement and transmission between APS and load-serving ESPs, including the development of the AISA protocols.
- The development of a detailed manual for ESPs and its subsequent modification through several presentations and workshops.
- The development of Schedule 10, which has been approved by the Commission and implements APS' rules and regulations for direct access service, as well as an ESP Service Acquisition Agreement to address the business relationship between APS and ESPs offering service in APS' distribution service area.
- Conducting internal training, including Code of Conduct training and training related to ESP service and other rule requirements, involving all affected APS, Pinnacle West and APSES employees.

Virtual Unbundling

Another significant undertaking for APS was to develop the "virtual" unbundling of Standard Offer service bills that the Electric Competition Rules directed. Under those rules, Standard Offer service was considered a "Noncompetitive Service." However, to allow customers to compare a "bundled" Standard Offer bill from their incumbent supplier with an offering from a competitive ESP, the Electric Competition Rules directed APS to show on its customer billing statements a breakdown of the bill by service component—such as generation, transmission, metering, and billing and collection costs.

This process and the reprogramming of APS' Customer Information System, which generates and prints the bills, has resulted in a second page being added to APS' normal bill to show the virtual unbundling and has required APS to increase staffing associated with its billing processes. Each year, that second page results in about 10.8 million extra sheets of paper being printed, stuffed into billing envelopes, and mailed to our customers.

APSES Activities

APSES is now in its fourth year of operation. It was formed along with the first competitive ESPs in Arizona and is one of the few remaining ESPs with an active CC&N. APSES received its CC&N in Decision No. 61669 (April 29, 1999). APSES has served direct access customers in both California and Arizona, and has been certificated to serve customers in Texas and Nevada. In California, APSES was the first ESP to deliver competitively-priced electricity to retail customers in 1997. In Arizona, it was the only ESP to serve customers in the service territories of all three major Arizona electric utilities—APS, Salt River Project and TEP. Today, APSES continues to serve direct access customers in California, and provides energy management services throughout the Southwest.

E. Transmission and Wholesale Market Activities

Although most of the Electric Competition Rules are focused on retail activities, some specifically apply to transmission or wholesale electric markets. APS has been significantly involved in these areas and in many cases has gone beyond the minimum requirements of the rules to adopt policies or practices that will help wholesale markets or provide transmission access for retail suppliers. Examples are discussed below.

AISA Protocols

Rule 1609(D) directs the formation of an Arizona Independent Scheduling Administrator ("AISA"). This organization was to help provide nondiscriminatory transmission access on an interim basis until a Regional Transmission Organization ("RTO") became functional. The AISA was designed to calculate the Available Transmission Capability of transmission paths, develop an Open Access Same-Time Information System ("OASIS"), implement and oversee the nondiscriminatory application of operating protocols to ensure statewide consistency for transmission access, provide a dispute resolution process, standardize scheduling procedures, and implement a transmission planning process. Essentially, the AISA was the first step in moving toward an RTO for Arizona.

APS provided much of the AISA's initial funding and spent thousands of employee hours to comply with the requirements in Rule 1609(D). More importantly, however, the process resulted in innovative protocols to facilitate retail direct access.

Specifically, retail transmission rights were to be allocated on a pro rata basis until auction and trading mechanisms were in place for these rights. This placed a significant burden on scheduling coordinators that are serving retail direct access customers, because a pro rata allocation on APS' transmission system would require some generation to come across each of APS' four key transmission delivery paths. For example, a scheduling coordinator might have purchased generation at Palo Verde, but would have to schedule on a pro rata basis from Four Corners, Navajo and Mead as well as Palo Verde. To mitigate this burden and facilitate the ability of ESPs to serve their customers, APS agreed to exchange up to 200 MW of its Palo Verde to APS transmission capacity with scheduling coordinators serving direct access customers in APS' service territory. Thus, ESPs could obtain all of their generation from the most liquid trading hub connected to APS' system and not be forced to schedule pro rata over all of APS' delivery paths.

To achieve regulatory acceptance of this approach, APS worked a great deal directly with FERC and Staff. The resulting protocols are now incorporated into APS' FERC-approved Open Access Transmission Tariff ("OATT").

Desert STAR and WestConnect

Rule 1609(F) requires each Affected Utility to "make good faith efforts to develop a regional, multi-state Independent System Operator or Regional Transmission Organization." The

RTO in which APS is participating pursuant to this rule, WestConnect, is based predominantly on the market design created by Desert STAR. Desert STAR discussions began as early as 1997 with the goal of creating an independent administrator for transmission operations in the Southwest (an Independent System Operator). APS was one of the original and most active participants in the Desert STAR discussions and helped coordinate the overall effort. The participants in the Southwest eventually created Desert STAR as a non-profit corporation and selected an independent board in 1999.

In early 2001, transmission owners in the area began to analyze the potential benefit of changing the basic framework of the organization into a for-profit entity. For a variety of reasons, it appeared that the better course was to sunset the Desert STAR organization completely and to create a new and innovative limited liability company structure for its successor, WestConnect. The WestConnect process resulted in a substantially complete proposed FERC tariff that was filed in October 2001.

The WestConnect applicants currently are APS, El Paso Electric Company, Public Service Company of New Mexico, and TEP. The Western Area Power Administration ("WAPA"), Salt River Project and the Southwest Transmission Cooperative are participating transmission owners. To achieve as broad and effective a regional system as possible, WestConnect has continued to explore having other transmission owners in Colorado, Wyoming and southern Nevada participate.

FERC issued an order conditionally approving WestConnect as an RTO on October 10, 2002.[20] Among the specific aspects of WestConnect that were approved in that order were:

- A "license plate" pricing model, with a transition to highway-zonal in 2009;
- Physical rights congestion management model as a "day one" proposition;
- The governance structure and board selection process; and
- A revenue recovery mechanism for WAPA revenues lost as a result of the WestConnect pricing structure

Under APS' leadership, WestConnect is also exploring ways to accelerate a phase-in of certain RTO functions. That effort is geared toward finding ways to implement RTO functions earlier than the time required to create a formal organization and acquire systems and personnel for full operations, as well as to identify functions offering significant benefits in relation to their costs.

In addition, the Seams Steering Group-Western Interconnection ("SSG-WI") is serving as a discussion forum for facilitating the creation of a Seamless Western Market and for proposing resolutions to issues associated with differences in RTO practices and procedures. SSG-WI includes the California ISO, RTO West, WestConnect, and other market participants. APS is significantly involved in moving this group forward and offering solutions to issues raised.

20 *Arizona Public Service Company, et al.*, 101 FERC ¶ 61,033 (2002).

Western Electricity Coordinating Council

APS has been and continues to be a leader in the Western Electricity Coordinating Council ("WECC"). The WECC was formed in April 2002 by the merger of the Western Systems Coordinating Council ("WSCC"), the Southwest Regional Transmission Association, and the Western Regional Transmission Association. The WECC is responsible for coordinating and promoting electric system reliability, as had been done by the WSCC since its formation nearly 35 years ago. In addition to promoting a reliable electric power system in the Western Interconnection, the WECC has been important in promoting efficient competitive power markets, assuring open and non-discriminatory transmission access among members, providing a forum for resolving transmission access disputes, and providing a forum for coordinating the operating and planning activities of its 145 members.

APS is actively involved in almost every committee and group within the WECC. More than perhaps any other individual member, APS has taken a leadership role within the WECC. APS President and Chief Executive Officer, Jack Davis, serves on the WECC Board of Directors and is past Chairman of the WSCC. APS' Director of Transmission Planning and Operations, Cary Deise, is the current Chair of the Reliability Management System Reliability Compliance Committee and the Vice Chair of the Joint Guidance Committee and of the Planning Coordination Committee. Mr. Deise is also the former Chair of the Reliability Management Systems Standards Development Task Force and of the Operating Practices Subcommittee. APS employees serve on the Steering Committee of the Operating Committee, as Chair of the Information Management Subcommittee, as sub-regional study group Chair of the Operating Transfer Capability Policy Committee, and as Chair of the System Review Work Group within the Planning Coordination Committee. These voluntary commitments within the WECC go far beyond the minimum requirements expected of WECC members.

Joint Planning Efforts and Joint Use of Facilities

Joint planning, where several utilities coordinate to undertake planning or construction of projects that would not make economic sense for an individual company, also helps facilitate wholesale competition. While joint planning is neither new nor unique, the extent to which APS (as well as some other Arizona utilities) participates in joint projects and planning is significant when compared to other regional or national areas. APS also has a long and continuing history of joint planning and joint use of transmission and generation facilities locally, within Arizona, and in the Western United States.

At the WECC, joint planning efforts have primarily occurred through various committees including the Board of Trustees, the Regional Planning Committee, the Planning Coordination Committee, the Operations Committee, the Joint Guidance Committee, the Operating Transfer Capability Policy Group, the Technical Studies Subcommittee, the Reliability Subcommittee, the Compliance Monitoring and Operating Practices Subcommittee, and the Remedial Action Scheme Reliability Task Force. APS is active on many of these committees.

Regional joint planning efforts also have been undertaken through groups such as the Western Area Transmission Systems technical studies task force, which addressed the

Arizona/California/Nevada region. Also, the Four Corners technical studies task force addressed the Arizona/New Mexico/Utah/Colorado region. The Southwest Regional Transmission Association worked with utilities from West Texas, New Mexico, Arizona, Nevada, and Southern California. More recently, the Southwest Transmission Expansion Plan group has been established to study the Arizona/California/Nevada region's needs, including the Palo Verde to Devers II project. Again, APS has been an active participant in these studies.

Within Arizona, APS' joint planning efforts have been focused in groups such as WAPA's Joint Planning Agreement activities, the Central Arizona Transmission study group, and involvement in the Commission's Biennial Transmission Assessments. Local evaluations involving APS have resulted in the Company working with other utilities in areas such as Yuma, Casa Grande, Phoenix, and Douglas as well as in many other locations and with tribal utilities.

The joint planning activities discussed above have led to many significant joint participation projects involving APS. Three power plants are jointly owned by APS and other utilities, with the Palo Verde Nuclear Generating Station being the largest. The other jointly-owned plants are the Four Corners Power Plant and the Navajo Generating Station. In addition, the Yucca, Cholla, West Phoenix and Saguaro Power Plants include generation owned by non-APS participants on site.

With respect to transmission, there are 11 extra high-voltage lines in Arizona in which APS is a joint participant:

- Navajo-Westwing 500kV
- Navajo-Moenkopi 500kV
- Moenkopi-Yavapai 500kV
- Yavapai-Westwing 500kV
- Palo Verde-Westwing #1 500kV
- Palo Verde-Westwing #2 500kV
- Palo Verde-Rudd 500kV
- Hassayampa-Jojoba 500kV
- Jojoba-Kyrene 500kV
- Hassayampa-North Gila 500kV
- Perkins-Mead 500kV

In addition to these transmission lines, there are numerous instances where facilities share towers, poles, rights of way and easements with other utilities and districts. APS is continuing to pursue joint projects to further develop the transmission system, including the Palo Verde-Southeast Valley 500 kV project.

Joint transmission planning, joint project development, and the shared use of rights of way or facilities where appropriate has been a policy supported by both Staff and the Commission. These joint efforts allow for a more robust and more economical bulk-power system and for the construction of transmission projects that would be more difficult or potentially not practical if only a single utility was involved. Joint projects also do so while

reducing the environmental impacts of the facilities. It is a policy that APS believes appropriate in today's changing electricity marketplace and that APS will continue to pursue.

Interconnection Procedures and Generator Interconnections

APS has implemented interconnection procedures to make it easier for other companies to request interconnection service. APS was one of the first five utilities in the United States to use a pro-forma interconnection process and has adopted a standard Interconnection and Operating Agreement and interconnection procedures that have been approved by FERC.[21] Additionally, APS has helped develop interconnection procedures for the Navajo Project, Palo Verde, Hassayampa Switchyard and for the Mead-Phoenix Project. These procedures have helped take the uncertainty out of interconnections to these facilities, and facilitated such interconnections. Also, APS spent a great deal of time at FERC and with other market participants to develop a Standardized Generator Interconnection Agreement and Procedures in 2002, which ultimately resulted in a Notice of Proposed Rulemaking ("NOPR") on the subject in FERC Docket No. RM02-1.

APS has been proactive in working with, rather than against, generators on interconnection issues. For example, APS worked aggressively to site and then construct the Panda Gila River Interconnection Project, which consisted of two 500 kV transmission lines from Gila Bend to the Palo Verde–Kyrene 500 kV transmission line. Because the project crossed federal land, APS completed an Environmental Assessment with the Bureau of Land Management, and in nearly record time received a Finding of No Significant Impact from that agency. APS also constructed the project within the timeline required for the Panda Gila River power plant.

In the case of the interconnection of Reliant's Desert Basin Power Plant, APS interconnected the plant and upgraded APS' transmission system back to the Valley to accommodate Reliant's request for transmission capacity to reach the Valley or the Palo Verde Switchyard. APS did this in a timely manner that facilitated Desert Basin's schedule for construction and start-up.

Hassayampa Switchyard and the Common Bus Concept

One accomplishment that APS believes was very important to generators interconnecting to the Valley transmission system was the groundbreaking development of the common bus concept at the Hassayampa Switchyard. The Hassayampa Switchyard originally was proposed as a "satellite" switchyard to accommodate a large number of generation and transmission interconnections that could not connect to the Palo Verde Switchyard due to lack of space. Because Palo Verde is one of the largest market hubs in the Western United States, many generators desired a direct interconnection of their plants, which would allow a generator to deliver output to the market without having to pay transmission wheeling charges.

APS worked with Salt River Project and the other Palo Verde Switchyard owners to "extend" the Palo Verde Switchyard to the Hassayampa Switchyard by creating a "common

[21] Attachments M and N to APS' OATT.

bus." By constructing such a "common bus," a generator interconnecting at Hassayampa is, in effect, treated as though it is interconnected at Palo Verde and therefore does not have to pay any additional transmission wheeling to move between the Palo Verde Switchyard and the Hassayampa Switchyard.

APS was a principal contributor in securing FERC approval of the novel "common bus" concept. The approval of this concept was combined with an express recognition from FERC for the innovative solution in aiding the wholesale market in the West. FERC also made it a point to state that the concept went beyond what was envisioned in FERC Order 888:

> [D]esignating the current Palo Verde Switchyard as a single point of receipt goes beyond what the Commission envisioned in Order No. 888, yet is, nonetheless, consistent with or superior to the pro forma tariff.... Because numerous market participants' generation will be interconnected to the common bus facility, this single point of interconnection...should become a major regional trading hub. Moreover, this expansion of the common bus designation will help alleviate short-run shortages and promote competition in the Western markets, which is consistent with our Western Markets Order to remove obstacles to increased electric generation in the Western United States.[22]

Regional Interconnection and Reserve Sharing

Finally, APS has taken an active role in developing increased regional interconnection and in reserve sharing. The Southwest Reserve Sharing Group ("SRSG") allows for sharing of contingency reserves among participants to realize more efficient and economic power system operations while maintaining the reliability of the interconnected system. Twelve load serving entities participate in the SRSG. APS is closely involved in the operation of SRSG and an APS employee chairs the SRSG Operating Committee.

Recently, SRSG authorized Duke Arlington Valley to join the group and both Panda Gila River and Mirant have applications pending. Although the original purpose of the group was to provide for reserve sharing among traditional load serving utilities, expanding the membership to include merchant generators could allow them to carry fewer reserves on their own. Thus, it provides a way to "firm" some of their power sales in a more economical way, and fosters the development of a competitive wholesale market.

F. The California and Western Energy "Crisis" and FERC Investigations

Although in 1999 the focus of electric restructuring was directed at retail direct access, the experience of California in 2000 and 2001 abruptly placed wholesale markets at center stage. Due to the interconnected nature of the Western United States' electric grid, this "crisis" extended far beyond the borders of California and is an important backdrop for considering actions taken by APS and its affiliate, PWEC, during this period.

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22 *Arizona Public Service Co., et al.*, 96 FERC ¶ 61,156 (2001).

The Western Energy Crisis

The West experienced unusually high electricity prices during 2000 and 2001. High natural gas prices from the summer of 2000 through the winter of 2000-2001, in combination with accelerated electric demand, generation failures, flawed regulation and transmission constraints combined to create these extraordinary wholesale electric prices. To make matters worse, from June through August 2000, California experienced one of the hottest summers in 106 years of record-keeping. Then, in November, average temperatures were unusually low.

This atypical weather helped drive load growth as temperature-sensitive customers increased their demand. Low snow pack from the winter and lower rainfall in the summer of 2000 reduced western area hydropower output. Specifically for California, the state's market design, which relied on the spot market for much of its needs, and the lack of demand response and under-scheduling of load by the major California investor-owned utilities exacerbated the problem. Finally, the forced divestiture of generation left California utilities without any backstop to high wholesale prices. By September 2000, the state's three investor-owned utilities had deferred more than $3 billion in wholesale power costs. By November 2000, the same utilities had deferred $6 billion of wholesale power costs because they were precluded from passing such costs through to ratepayers. By January 2001, both Southern California Edison and PG&E were downgraded to junk status by the major credit ratings agencies and one, PG&E, was forced into bankruptcy.

The backlash of two bad years in California began to play out politically. In early 2001, the California legislature stepped in to authorize the California Department of Water Resources ("CDWR"), rather than the cash- and credit-strapped utilities, to make power purchases. By June, CDWR had entered into about $43 billion worth of long-term energy contracts in an effort to stabilize the energy crisis in the state. It also purchased more than $10 billion of wholesale energy on the spot and day-ahead markets. A subsequent report by the California Auditor General summarized the circumstances surrounding the execution of long-term contracts by CDWR:

> Forced to act quickly to restore stability to the State's electrical power system during the California energy crisis of 2000 and 2001, the Department of Water Resources...entered into a number of long-term contracts for electricity, many of which later proved to be unfavorable to the State.[23]

That same report notes that CDWR likely will be responsible for managing the portfolio of long-term contracts for "much of the next decade."

As another California Auditor General's report noted, "CDWR's capabilities were dwarfed by the magnitude of its mission under the power purchasing programs."[24] By early 2002, however, California agencies had filed complaints with FERC to void these contracts, alleging that they were entered into at a time when power producers were manipulating the

[23] Bureau of State Audits, California Energy Markets, Report No. 2002-009 (April 2003).

[24] Bureau of State Audits, California Energy Markets, Report No. 2001-009 (December 2001).

market. The state continues to both renegotiate and, as part of the investigations discussed below, litigate the long-term contracts that it entered into in 2001.

Western Markets Investigations

Investigations into the Western energy crisis are continuing at FERC. Investigations have been initiated into the California and the Northwest markets and a West-wide probe into the distortion in the electric and natural gas markets after the collapse and subsequent admissions of market manipulation by Enron. These proceedings are discussed below.

Due to their load-serving obligations, particularly during the volatile markets of the time, APS and its affiliates often purchased blocks of energy to meet load requirements and sold any excess into Western spot markets, including those in California. On balance, APS and its affiliates were buyers in the California markets and are owed a net of several millions of dollars in refunds under the proposed findings of the administrative law judge in the California refund investigations at FERC. Further, APS and its affiliates entered into contracts with other Western entities to buy and sell energy throughout this period.

For the California markets, in *San Diego Gas & Electric Company v. Sellers of Energy and Ancillary Services Into Markets Operated by the California Independent System Operator and California Power Exchange*, Docket Nos. EL00-95-000, et al., a number of parties purchasing energy in markets operated by the California Independent System Operator ("CAISO") or the California Power Exchange have asserted that the prices they paid for such energy were unjust and unreasonable under the Federal Power Act and that refunds should be made in connection with sales into those markets from October 2, 2000 through June 20, 2001. APS supplied energy to these markets during this period, and has been an active participant in the proceedings.

In orders issued on November 1, 2000, December 15, 2000, June 19, 2001, July 25, 2001 and December 19, 2001, FERC concluded that the electric market structure and market rules for wholesale sales of energy in California were flawed and, in conjunction with an imbalance of supply and demand, have caused unjust and unreasonable rates for short-term energy under certain conditions. FERC ordered various modifications to the market structure and rules in California and also established a fact-finding hearing before an administrative law judge to calculate refunds for spot market transactions in California.

FERC directed the administrative law judge to make findings of fact with respect to: (1) the mitigated price in each hour of the refund period; (2) the amount of refunds owed by each supplier according to the methodology established; and (3) the amount currently owed to each supplier (with separate quantities due from each entity) by the CAISO, the California Power Exchange, the investor-owned utilities, and the State of California.

APS was a seller and a purchaser in the California markets at issue in this proceeding, and to the extent that refunds are ordered, APS should be a recipient as well as a payor of such amounts. On December 12, 2002, Presiding Administrative Law Judge Bruce Birchman issued Proposed Findings of Fact with respect to the refunds. The Proposed Findings of Fact include a

"ballpark summary" of amounts owed to and amounts owing from each supplier in the CAISO and California Power Exchange markets. Under the judge's preliminary calculations, APS is owed over $5 million in refunds. In March 2003, FERC issued an order accepting the great majority of the Proposed Findings of Fact, but revised the refund calculations to allow additional refunds based upon an adjustment in natural gas pricing. Final refund amounts will not be established until the appropriate adjustment to the natural gas pricing is determined, an issue still pending on rehearing at FERC.

On November 20, 2002, FERC reopened discovery in these proceedings pursuant to instructions of the U. S. Court of Appeals for the Ninth Circuit that FERC permit parties to adduce additional evidence of potential market manipulation for the period January 1, 2000, through June 20, 2001. Discovery was open until February 28, 2003, at which time parties submitted additional evidence and proposed findings. Action on these findings is still pending at FERC.

For the Pacific Northwest markets, in *Puget Sound Energy Inc., et al.,* Docket No. EL00-10, et al., FERC ordered a preliminary evidentiary hearing to facilitate development of a factual record on whether there may have been unjust and unreasonable charges for spot market bilateral sales in the Pacific Northwest for the period beginning December 25, 2000 through June 20, 2001. FERC required that the record establish the volume of the transactions, the identification of the net sellers and net buyers, the price and terms and conditions of the sales contracts, and the extent of potential refunds. APS supplied energy to the Pacific Northwest markets during this period, and has been an active participant in these proceedings as well.

On September 24, 2001, Presiding Administrative Law Judge Carmen Cintron concluded that prices in the Pacific Northwest during the period December 25, 2000 through June 20, 2001 were the result of a number of factors in addition to price signals from the California markets, including the shortage of supply, excess demand, drought, and increased natural gas prices. Under these circumstances, the Judge ultimately concluded that the prices in the Pacific Northwest were not unreasonable or unjust and refunds should not be ordered in this proceeding. FERC is currently reviewing the Judge's Report and Recommendations.

On December 19, 2002, FERC opened a new discovery period, through February 28, 2003, to permit the parties to adduce additional evidence for the period January 1, 2000, through June 21, 2001. Parties filed evidence and proposed findings for FERC's review in conjunction with the proposed findings of Judge Cintron. Action on these findings is still pending at FERC.

FERC also has launched an investigation of price manipulation in the western markets. The FERC's Staff issued a final report on the investigation in March 2003. FERC continues to consider the Staff recommendations and review additional information gathered on this topic.

G. The Commission's Inquiry Into the Electric Competition Rules

APS and Pinnacle West did not watch events develop in California and the Western United States without evaluating their potential impact on Arizona. Much like the California utilities, APS was in a potentially precarious position as electric restructuring began to be

implemented. Specifically, APS was short of needed capacity and was not able to construct new capacity itself due to the divestiture requirements in Rule 1615 and its retail Code of Conduct. Also, APS was subject to a rate reduction schedule in its 1999 Settlement that restricted the Company's ability to pass wholesale power costs through to customers if they were to increase significantly.

Indeed, one of the shortcomings in the 1999 Electric Competition Rules was that incumbent utilities such as APS retained the obligation to serve customers—even those returning from competing generation suppliers—with reliable and reasonably-priced service, but due to the divestiture requirement were prohibited from constructing generation to meet that obligation. Thus, to meet APS' growing electric load and to ensure reliability for APS Standard Offer customers, Pinnacle West embarked upon a two-pronged effort. First, Marketing and Trading entered into a series of arrangements (both financial and physical) to manage wholesale electric and natural gas market price risk and reliability until such time actual generation plants could come on-line to perform the same function in a longer-term and more stable manner. Secondly, PWEC began and completed all the activities to construct approximately 1,700 MW of new generation that serves APS' customers today.[25]

To obtain permanent financing for the more than $1 billion in new PWEC investment, PWEC and Pinnacle West relied on the Commission's assurance that PWEC would receive the existing APS generation assets. Accordingly, Pinnacle West provided interim financing through a series of short-term bridge loans. And, despite the later opportunity during the California energy crisis to sell the output of the new PWEC units forward in that lucrative market, it was held back for future use by APS customers.

Throughout this period, APS kept the Commission informed of its concerns. By autumn 2001, APS had concluded that wholesale power markets were too volatile to support implementation of the competitive bidding and wholesale procurement plan required by Rule 1606(B). Under that rule, starting in January 2003 and following the divestiture of the APS generation, APS would have to look to the wholesale market for all of its Standard Offer power needs, with at least 50 percent coming through some sort of competitive bidding process. Given the failures in the wholesale markets in 2000 and 2001, APS negotiated a proposed purchase power agreement involving PWEC that would require PWEC to meet APS' full requirements at cost-based rates, and would include a more modest competitive bidding component. This proposal would have allowed the APS generation to be divested, thus satisfying that requirement of the Electric Competition Rules, while still providing for some competitive bidding for wholesale supply.

Because the proposed agreement would not meet the literal requirements of Rule 1606(B), APS filed its Request for Partial Variance with the Commission on October 18, 2001. In that filing, APS requested that the Commission approve the proposed purchase power agreement and grant a partial variance to Rule 1606(B) to allow APS to implement the

[25] This capacity figure does not include temporary generation installed in the Summer of 2001 by PWEC at a cost of approximately $30 million.

agreement. APS made it clear, however, that if the Commission disagreed with its application the Company would proceed with "good faith compliance with Rule 1606(B) as written."[26]

Also in late 2001, APS took note that retail competition in Arizona was not developing due at least in part to the California energy crisis. Skyrocketing and volatile wholesale prices also made it impractical for ESPs to compete in Arizona against fixed or declining Standard Offer rates. And, the demise of retail competition in California and Nevada, and its delay in New Mexico, reduced Arizona to a "stand-alone" play for ESPs in the Desert Southwest, and many left the state or went out of business. Additionally, the Electric Competition Rules were found unconstitutional by a trial court judge, and are still on appeal with the Arizona Court of Appeals.

In December 2001, then-Chairman Mundell filed a letter with the Commission's docket control requesting that parties respond to a series of questions on general issues relating to electric restructuring in Arizona. On January 22, 2002 a generic docket on electric restructuring was opened. On April 25, 2002, at a Special Open Meeting, the Commission stayed indefinitely the scheduled hearing on APS' Request for Partial Variance. Instead, it ordered that certain issues relating to electric restructuring be addressed through the generic docket and a hearing on a wide variety of issues was held in June 2002.

After the hearings, the Commission issued Decision No. 65154 resolving so-called "Track A" issues. In the Track A Decision, the Commission in part ordered APS to cancel any plans to divest generation, stayed Rule 1606(B), and ordered APS to file a modified Code of Conduct. In the Track A decision, the Commission noted:

> In retrospect, it was a good idea to delay divestiture and competitive procurement in the APS and TEP Settlement Agreements, given what has happened in the last two or so years, including the experience in California; the market volatility and illiquidity; and the lack of public confidence in the transition to electric deregulation and the ability of regulators to prevent price spikes, ensure reliable service, and prevent bankruptcies.[27]

In staying Rule 1606(B), the Commission directed that competitive solicitation requirements be developed in a "Track B" proceeding. The Commission specifically stated in its Track A decision that Rule 1606(B) and the divestiture requirements of Rule 1615 were inextricably linked.[28] Although the Commission completely suspended divestiture, it nonetheless ordered APS in the Track B proceeding to competitively solicit for substantially more than the Company's net short capacity and energy requirements, and to include in addition economy energy and reliability must run generation. The Track A order, however, did not address the transitional implications to Pinnacle West and its affiliates of the Commission's changes to the

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[26] *See* APS' April 19, 2002 Motion for Threshold Determination, Docket No. E-00000A-02-0051, et al., at 3.

[27] Decision No. 65154 at 22.

[28] *Id.* at 24.

1999 Settlement or the significant costs APS incurred in compliance with and reliance on that Settlement.[29]

[29] APS appealed the Track A Decision to the Maricopa County Superior Court and Arizona Court of Appeals. While those appeals are still pending, APS and Staff agreed to Principles of Resolution on December 13, 2002. The Principles of Resolution narrow APS' claims in the Track A appeals and will provide the Commission with the opportunity to address the remaining claims in the Company's upcoming rate case.

IV. COMPLIANCE WITH ISSUES RAISED

A. Electric Competition Rules

In Section III, this Report discusses from an overall perspective the Company's and its affiliates' compliance with the Electric Competition Rules. This section focuses on those compliance efforts through the principal requirements of the specific Electric Competition Rules that apply.

Rule 1602. Rule 1602 provides that customers will be eligible for competition pursuant to the phase-in schedule in Rule 1604, and prohibits an Affected Utility's ESP affiliate from providing services in any other Affected Utility's service area until its affiliated utility has commenced direct access. Pursuant to Rules 1602 and 1604 and Decision No. 61973, customers in APS' service territory were eligible for competition on July 1, 1999. Also, APS' competitive ESP affiliate, APSES, did not provide service in another Affected Utility's service territory until APS' service territory was open for competition.

Rule 1603. This rule outlines the requirements for an ESP to obtain a competitive CC&N. In addition to standard filing requirements, this rule directs Affected Utilities to negotiate in good faith in developing Service Acquisition Agreements between the utility and an ESP. APS' competitive ESP affiliate, APSES, obtained a CC&N in Decision No. 61669 (April 21, 1999) in which the Commission determined that it had complied with the requirements of this rule. Also, APS was the first Affected Utility to develop and have approved an ESP Service Acquisition Agreement and negotiated its agreements with ESPs in good faith. That Service Acquisition Agreement was used by Staff as a template for the development of agreements by other Affected Utilities.

Rule 1604. Rule 1604 sets forth the phase-in for direct access. The initial date to commence the phase-in would be established for each Affected Utility, but all customers were to be eligible for direct access no later than January 1, 2001. Also, Affected Utilities were directed to file residential phase-in programs and file quarterly reports. Utilities were also to file a report detailing possible mechanisms to provide benefits, including rate reductions of 3 to 5 percent, for all Standard Offer customers.

APS commenced its phase-in as of July 1, 1999, the date specified in Decision No. 61973. The initial amount of commercial and industrial load that was eligible was 653 MW. APS filed its Residential Phase-In Program on September 15, 1998 and received Staff approval of that program on October 19, 1998. The Company submitted a revised Residential Phase-In Program on December 21, 1998 pursuant to Decision No. 61272. That revised program reflected changes in the rules that increased the number of residential customers eligible for direct access. APS filed its initial Quarterly Report with the Commission on February 15, 2000, covering October through December 1999. This report identified all of the customer education meetings presented by APS, bill stuffers regarding competition, and special customer mailings on retail direct access. APS' final report pursuant to this rule was filed on February 14, 2003 for 2002.

Finally, the mechanism to provide benefits to Standard Offer customers was included in the 1999 Settlement. In the 1999 Settlement, APS provided rate reductions to Standard Offer customers totaling 7.5 percent by July 2003, rather than the 3 to 5 percent suggested in the rule.

Rule 1605. This rule requires an entity providing Competitive Services to obtain a CC&N, and that certificated ESPs may offer services under bilateral or multilateral contracts with retail consumers. As noted above, APSES was certificated to provide Competitive Services, and offered such services under bilateral and multilateral contracts with retail consumers.

Rule 1606. This rule specifies services that must be made available under retail electric competition. Rule 1606(A) requires Affected Utilities to make Standard Offer service and Noncompetitive Services available at regulated rates. It also requires that after an Affected Utility divests its generation, it will be required to act as the Provider of Last Resort in its service area. Rule 1606(B) had required Utility Distribution Companies, post-divestiture, to obtain their generation from the wholesale market through prudent arm's-length transactions with at least 50 percent through a competitive bid. Rule 1606(C) includes requirements for Standard Offer tariffs, while Rule 1606(D) addresses Noncompetitive Services (also called direct access) tariffs. Other provisions of Rule 1606 require Affected Utilities to accept power and energy delivered by an ESP to their systems for delivery to the ESP's customers, and for the provision of consumer data by the utility to ESPs.

Pursuant to Rule 1606(A), APS made available Standard Offer and Noncompetitive Services at regulated rates when its service territory was opened to competition. Rule 1606(B) was never in effect for APS, as it was stayed until January 1, 2003 by Decision No. 61973 and subsequently indefinitely stayed by the Commission's Track A Decision.[30]

As to the other requirements of Rule 1606, APS filed and the Commission accepted Standard Offer tariffs and unbundled direct access tariffs. Standard Offer and direct access tariffs were filed by APS on September 29, 1999 and were approved on November 10, 1999 with an effective date of October 1, 1999. In July 2000, APS began including an additional page with each customer's bill to identify "Competitive Services" and "APS Delivery Service Information," showing the calculated price for each service based on the customer's usage. This page was intended to allow customers to compare their Standard Offer rates with potential rates from competitive ESPs.

APS also made arrangements to accept power and energy delivered to APS' distribution system by other Load Serving Entities, and APS made the process for making such deliveries more commercially reasonable for ESPs by helping to form the AISA and then adopting the AISA protocols that allowed ESPs to supply their generation from Palo Verde rather than pro rata across APS' various transmission delivery points. Finally, APS provided ESPs with the

[30] APS had requested a partial variance to Rule 1606(B) through a filing made in October 2001, over a year prior to the date that the rule was supposed to take effect for APS. Although now rendered moot by the Track A decision, APS clearly stated in that proceeding that if the Commission denied the Company's Request for Partial Variance, APS would implement Rule 1606(B) as written and divest its power plants to PWEC as required by the 1999 Settlement and Rule 1615. *See* APS' April 19, 2002 Motion for Threshold Determination, Docket No. E-00000A-02-0051, et al., at 3.

consumer data as required by this rule. The ESP Service Acquisition Agreement that APS developed was approved by Staff on August 2, 1999, and APS' Schedule 10, Terms and Conditions for Direct Access, was approved in Decision No. 61270 (December 2, 1998).

Rule 1607. This rule provides that Affected Utilities were to be entitled to recover *all* of their stranded costs, although they were expected to mitigate or offset such costs by reducing costs, expanding wholesale or retail markets, or offering a wider scope of permitted utility services for profit. The rule provided that Affected Utilities would file stranded cost estimates and, following a hearing, the Commission would approve mechanisms for stranded cost recovery.

The Commission acknowledged in Decision No. 61973 that APS had at least $533 million net present value of stranded costs. Although the rule entitled APS to fully recover those stranded costs, APS agreed to write down $234 million of prudently incurred costs in the 1999 Settlement. The 1999 Settlement constituted APS' compliance with the stranded cost filing requirement in Rule 1607. The 1999 Settlement also addressed the various mechanisms identified in this rule.

Rule 1608. This rule provides that each utility shall file for a Systems Benefit Charge to collect system benefits costs from all customers. APS has a system benefits charge in place pursuant to this rule, although the EEASE fund was eliminated in Decision 59601 (April 24, 1996). Amounts collected through the System Benefits Charge are applied by APS to the Commission's Environmental Portfolio Standard.

Rule 1609. Rule 1609 includes a number of provisions relating to transmission and distribution access. Rule 1609(A) and (B) require Affected Utilities to provide open access to their transmission and distribution systems, but to retain the obligation to ensure that these systems are adequate to serve the utility's customers. Rule 1609(C)-(G) set forth the Commission's support for the formation of an RTO and the AISA, and provide requirements relating to the formation of those entities. Rule 1609(H) addresses the use of scheduling coordinators to aggregate customers' schedules. Rule 1609(I) addresses cost-sharing for must-run services and requires the AISA to develop protocols regarding must-run services. Finally, Rule 1609(J) provides that statewide settlement practices be adopted.

APS has provided for non-discriminatory open access to its transmission and distribution systems to allow ESPs to reach APS retail wires customers. As discussed above, APS helped develop and implemented the AISA protocols to make such access easier for ESPs seeking to serve APS load. APS has also provided for adequate distribution and transmission import capability and has not had an outage or curtailment related to a lack of transmission import capacity since the rules were adopted.

APS has been active in supporting the AISA and adopting the resulting protocols pursuant to Rule 1609(D). APS has now focused its efforts on forming the WestConnect RTO, as required by Rule 1609(F). Must-run protocols have been developed to ensure that must-run services are available to ESPs if necessary. Finally, APS has developed a fair and reasonable generation settlement process pursuant to Rule 1609(J).

Rule 1610. This rule requires in-state reciprocity for Public Power Entities (primarily Salt River Project and a few cities) and other non-jurisdictional electric utilities (primarily special purpose districts). It is not directly applicable to APS.

Rule 1611. Rule 1611 discusses rates that can be charged by ESPs for Competitive Services and the filing of contracts with the Commission's Staff. APSES has competitive rates on file with the Commission that were approved when its CC&N was granted.

Rule 1612. Rule 1612 includes a number of provisions relating generally to service quality, consumer protection, safety, and billing requirements. APS complies with all of the requirements in this rule, and has implemented practices to ensure that the rules are carried out. For example, Rule 1612(D) provides that a residential customer shall have the right to rescind its authorization to change providers of any service within 3 business days by providing written notice. APS has developed its direct access systems to specifically recognize, support and track this requirement. Additionally, APS has been very active in the Commission's Process Standardization Working Group, which is streamlining many of the requirements in this and other rules.

Rule 1613. This rule sets forth various reporting requirements, information to be contained in the reports, and a reporting schedule. APS and APSES have each submitted the reports required by this rule. APS filed its initial semi-annual Retail Electric Competition Report with Staff on April 17, 2000 and filed its most recent report on April 15, 2003. Also, pursuant to Decision No. 64810, APS filed its initial report for Estimates on First and Final Bills on April 15, 2003 and will continue to file such reports semi-annually with Staff.

Rule 1614. This rule sets forth certain administrative requirements. Rule 1614(A) provides that ESPs may file additional tariffs with the Commission. Rule 1614(B) provides that contracts filed under the rules shall not be open to public inspection except on order of the Commission. Rule 1614(C) provides that parties may request variations or exemptions from the terms or requirements of *any* of the rules. This was the authority that supported APS' October 2001 Request for Partial Variance to Rule 1606(B). Finally, Rule 1614(D) and (E) provide for dispute resolution (which has never been invoked against APS) and requires Staff to implement a customer education program, respectively.

Rule 1615. Rule 1615(A) required the separation of "all competitive generation assets and competitive services" by January 1, 2001. Pursuant to Decision No. 61973 and the 1999 Settlement, APS was granted an extension of that deadline until January 1, 2003. Although the rule uses the term "competitive generation assets," the Concise Explanatory Statement that accompanies the rule explains that it is "clear that competitive generation includes all generation except for Must-Run Generating Units."[31] Moreover, the 1999 Settlement specifically listed the generation that APS was required to divest, and it included *all* generation, including generation that at times would be considered as Must-Run Generating Units. APS has not otherwise

[31] Decision No. 61969 at 60. This also supports why it was reasonable for APS to assume that any new generation constructed at APS after the rules were adopted would be considered a "competitive service" even if used to supply "non-competitive" Standard Offer customers. That was clearly the position of the Commission at the time the rules were adopted.

provided Competitive Services after the effective date of the rule. Such services are instead provided through APSES.

Rule 1616. This rule sets forth the requirements for a Code of Conduct between Affected Utilities and subsidiaries that will offer Competitive Services as a competitive electric affiliate. The rule requires such Codes of Conduct to address nine enumerated subjects. APS filed and the Commission approved a Code of Conduct in Decision No. 62416. That decision concluded as a matter of law that the Code of Conduct met the requirements of Rule 1616 and Decision No. 61973.

Rule 1617. Rule 1617 addresses the disclosure of information through a consumer information label. APS participated in the Consumer Education Working Group to formulate a standard disclosure label which provides customers with information to assist them in choosing an electric supplier. The label for APS is posted on the Company's Web site, is provided to all new customers, and is provided to existing customers upon request. Additionally, APS includes with each customer bill a second page that reflects billing and cost information to allow customers to compare APS' Standard Offer service with competitive offers. The APS customer information label is provided in the various Electric Competition Reports that APS submits pursuant to the rules.

B. Decision No. 61973

Decision No. 61973 approved the 1999 Settlement. Although many of the provisions in that agreement were changed by the Commission, APS has continued to comply with its obligations under the 1999 Settlement. That compliance is generally discussed below.

General Obligations of the Settlement

The 1999 Settlement provided for the implementation of retail direct access in APS' service territory. Pursuant to the requirements in that agreement, APS opened its service territory to competition, and allowed its previously exclusive CC&N to be modified to permit retail access.

Rate matters were also addressed in the 1999 Settlement, and APS filed unbundled direct access rates with its Commission filing of the Settlement. Those rates were revised to reflect metering, meter reading and billing credits and were submitted with the Addendum to the Settlement Agreement. The Commission approved the Company's unbundled rates in Decision No. 62035 (November 10, 1999). APS also reduced Standard Offer and direct access rates in the amounts required by the Settlement, which, following the July 1, 2003 reduction, will result in a 7.5 percent rate reduction for residential Standard Offer customers since the Settlement was approved. Those rate reductions will have saved APS customers more than $400 million through June 30, 2004.

The Settlement also required APS to file and the Commission to approve adjustment clauses to provide for full and timely recovery beginning July 1, 2004 of certain reasonable and prudent costs in four categories—meeting Standard Offer obligations, costs associated with

customers returning from direct access to Standard Offer service, compliance costs associated with the Electric Competition Rules, and future Commission-approved system benefits programs. APS timely filed its application for such adjustment clauses on May 31, 2002. APS also agreed at the request of Staff to extend the December 31, 2002 date required in the Settlement for the Commission to approve the adjustment clauses. APS will also, pursuant to the Settlement, file a general rate case with prefiled testimony prior to June 30, 2003.

Additionally, the 1999 Settlement addressed stranded cost recovery. Under the Settlement, APS agreed to write off $234 million of allowable and prudently-incurred costs. As required, APS wrote off that amount on its accounting books.

APS also had agreed in the 1999 Settlement to not recover one-third of the costs associated with the transfer of the APS generation to an affiliate. The Commission explained that its rationale for reducing the amount of transfer costs that could be deferred and recovered by APS was because "the Company is making a business decision to transfer the generation to an affiliate instead of an unrelated third party."[32]

Corporate Restructuring and Divestiture

The original Settlement provided that APS would form an affiliate to receive the APS generation assets that were required to be divested by the Electric Competition Rules and the Settlement. Based on comments by intervenors, this original language was revised to make explicit that the generation affiliate would be formed as a subsidiary of Pinnacle West, not of APS. APSES, which is the retail ESP affiliate of APS, had already been formed as a subsidiary of Pinnacle West. It received a CC&N from the Commission in Decision No. 61669 (April 21, 1999). PWEC was formed after the Settlement was approved as the affiliate to receive the APS generation assets. The decision approving the 1999 Settlement found that the formation of a generation affiliate (PWEC) was in the public interest. The approval also affirmed that APS would purchase from its generation affiliate at market based rates and that such purchases were in the public interest. As discussed in more detail below, APS has purchased from PWEC and Pinnacle West under those parties' market based rate tariffs.[33]

APS began implementing, almost immediately after the Settlement was approved, the process necessary to transfer the APS generation to PWEC within the two-year extension granted by the Commission. The generation assets that were to be transferred under Decision No. 61973 included all of APS' generation units (other than solar and distributed generation), including Must-Run Generation Units.[34] APS filed for Nuclear Regulatory Commission approval for license transfers and for FERC approval for the transfers. APS also initiated discussions with other regulatory agencies, such as the Arizona Department of Environmental Quality, for the transfer of permits. And, filings were made with the Internal Revenue Service to confirm the tax implication of the transfers.

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32 Decision No. 61973 at 10.

33 *See id.* at Attachment 1, § 4.1.

34 *See id.* at Exh. C.

In connection with the restructuring, the Commission granted Pinnacle West certain waivers of the Affiliated Interest Rules, A.A.C. R14-2-801, *et seq.* Although APS and Pinnacle West remained subject to other requirements of the Affiliated Interest rules, Pinnacle West was granted a wavier of Rule 801(5) and Rule 803, which address organization and reorganization of holding companies, to the extent that a reorganization did not directly involve APS. Essentially, this waiver allowed Pinnacle West to reorganize, form, buy or sell non-Utility Distribution Company affiliates and acquire or divest interests in non-Utility Distribution Company affiliates, without Commission approval. Also, Rule 805(A), which requires annual reports of diversification activities and plans, was limited to apply only to APS. Finally, the decision granted a waiver to APS and its affiliates from annual reporting requirements relating to five categories of information under Rule 805(A). The Commission concluded that these waivers were in the public interest and granted them in Decision No. 61973. In Decision No. 65796, however, the Commission revoked waivers granted in the 1999 Settlement during the term of the PWEC loan approved in that decision.

Other Obligations

The Settlement also provided that APS would withdraw its litigation challenging the Electric Competition Rules and stranded cost decisions when Decision No. 61973 was final and no longer subject to appeal. APS dismissed its appeals on January 11, 2002, after the Arizona Supreme Court affirmed the Commission's decision and the 1999 Settlement, holding that the Settlement was a valid and binding obligation of the Commission.

Finally, the Settlement contained a number of miscellaneous provisions, each of which APS has honored. The Company has continued to support funding of the Arizona Community Action Partnership and continues its low income rates under their current terms and conditions. Also, APS has actively supported the AISA and adopted AISA protocols. And, APS filed its interim proposed Code of Conduct within 10 days of approval of the 1999 Settlement.

Supply of Generation

One of the requirements in the 1999 Settlement that was added in the November 24, 1999 addendum was that APS file an initial proposed Code of Conduct that would include a provision to govern the supply of generation during the two-year extension granted for both divestiture and compliance with Rule 1606(B) to ensure that APS did not "give itself an undue advantage over the ESPs."[35] On October 28, 1999 APS filed an initial proposed Code of Conduct which contained the following provision:

> Prior to the divestiture of APS generation pursuant to [Decision No. 61973], APS generation will not be sold on a discounted basis to Standard Offer customers without the express permission of the [Commission].

Both the language approving the Settlement and the comments filed by Enron to that proposed Code of Conduct illustrate that the issue regarding "the supply of generation" was not

[35] Decision No. 61973 at 12.

how APS would procure power from other suppliers, but rather how APS would use the generation that it still controlled.[36] For example, Enron agreed that the APS proposal restricting discounts to Standard Offer service was appropriate. But Enron argued that the Code of Conduct should address "how APS will *dispose* of excess capacity" and whether APS would "willingly *sell* excess capacity in the open marketplace" or whether APS should "be required to *sell* excess power to the highest bidder."[37] New West Energy, which was an ESP, filed comments supporting the Code of Conduct as filed by APS. The Arizona Transmission Dependent Utilities Group filed comments but did not address this issue. No other parties, apart from Staff, commented on the proposed Code of Conduct.

Staff filed testimony opposing the Code of Conduct filed by APS and attached to the testimony of its expert witness its own proposed Code of Conduct. Staff's proposed Code of Conduct contained the same language regarding generation supply prior to divestiture as in APS' original proposed Code of Conduct. After a hearing was conducted on the matter, APS met with Staff and reached a stipulated Code of Conduct based on Staff's proposed Code of Conduct that included changes from Staff and intervenors in the case. The two specific recommendations from intervenors that were not accepted, including one from Enron on the language in the "generation supply" provision, were clearly identified for the Commission.

APS' and Staff's Joint Proposed Code of Conduct filed in 2000 contained a provision regarding the supply of APS generation prior to divestiture and the Commission determined that it met the requirements of Decision No. 61973. APS has complied with that Code of Conduct provision and there was never a requirement to address the procurement of generation by APS in the Code of Conduct.

The stipulated APS Code of Conduct, including the language on generation supply that was quoted above, was approved by the Commission in Decision No. 62416. In that decision, the Commission concluded that the Joint Proposed Code of Conduct, as amended by the decision, "satisfies the requirements of A.A.C. R14-2-1616 and Decision No. 61973" and approved the Code of Conduct.

C. APS' Code of Conduct

As explained above, the APS Code of Conduct applies to the conduct of APS and its interaction with its Competitive Retail Electric Affiliate, APSES. Both prior to and upon final approval of the APS Code of Conduct by the Commission, APS took significant and meaningful steps to ensure compliance with the APS Code of Conduct and the Policies and Procedures that implemented the APS Code of Conduct. Specifically, among other activities:

[36] Comments of Enron Corp. to APS' Proposed Code of Conduct, Docket No. E-01345A-98-0473, et al. (December 3, 1999) at 4-5.

[37] *Id.* at 5 (emphasis added).

- Interim training was provided to key groups prior to the final approval of the APS Code of Conduct by the Commission.

- Upon approval of the APS Code of Conduct, the Pinnacle West Business Practices Department implemented a comprehensive training program for employee groups identified as potentially having significant customer, ESP or public contact. The following key groups were provided training:

  - Call Center
  - Customer Account Management
  - Customer Operations
  - Division Offices
  - Design Project Leaders
  - Economic Development
  - Energy Delivery and Sales
  - Field Collections
  - Marketing
  - Outdoor Lighting
  - Siting
  - Technology Development

- Key leaders and shared services employees that could have significant interface with APS and APSES employees also received training.

- Employees that did not need the more comprehensive training were provided notice of the Commission Rules, the APS Code of Conduct and the Policies & Procedures through intra-company articles and were invited to call the Pinnacle West Business Practices Department with any questions.

- Sections on the APS Code of Conduct were added to existing training programs (*e.g.*, Leadership Academy, Survival Skills for Leaders, and Corporate Ethics Policy) and new training such as the on-line *Doing the Right Thing* course.

- APSES was physically separated from APS through a move to a different office building, APSES employees were required to have escorted access to APS facilities, and a separate phone switch was installed.

- Copies of the APS Code of Conduct and the Policies & Procedures were posted on the Pinnacle West Business Practices intranet site, along with copies of the FERC Code of Conduct and FERC Standards of Conduct.

- APS developed and implemented inter-affiliate agreements to govern transactions between affiliates, including APS and APSES. Those agreements required compliance with the APS Code of Conduct.

- The Pinnacle West Audit Services Department conducted periodic audits of compliance with sections of the APS Code of Conduct.

APS and APSES continue to comply with the APS Code of Conduct today, including the recent implementation of additional access restrictions due to the move of certain shared services functions back to APS.[38] And no one has alleged any violation of the APS Code of Conduct by either APS or APSES.

D. Other Applicable Law

1. FERC Requirements

Under the Federal Power Act, FERC has exclusive jurisdiction of most wholesale power and transmission issues. Thus, most of the applicable law relating to wholesale power procurement stems from FERC rules, decisions, or the Federal Power Act itself.

FERC Orders 888 and 2000

In April 1996, in Order No. 888, FERC found that unduly discriminatory and anticompetitive practices existed in the electric industry, and that public utilities that own, control or operate interstate transmission facilities had discriminated against others seeking transmission access.[39] It determined that non-discriminatory open access transmission services, including access to transmission information, and stranded cost recovery were the most critical components of wholesale electricity markets. FERC stated that its goal was to ensure that customers have the benefits of competitively priced generation. Order No. 888 required all public utilities that own, control or operate facilities used for transmitting electric energy in interstate commerce to: (1) file open access non-discriminatory transmission tariffs containing certain minimum, non-price terms and conditions; and (2) functionally unbundle wholesale power services from transmission services. APS has an open access transmission tariff on file with FERC and continues to provide non-discriminatory access to its transmission system in accordance with the requirements of Order No. 888.

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[38] Consistent with the Track A Decision, APS submitted a proposed Code of Conduct to the Commission on November 12, 2002. That proposed Code of Conduct is anticipated to be the subject of Commission review later this year.

[39] Promoting Wholesale Competition Through Open Access Non-discriminatory Transmission Services by Public Utilities and Recovery of Stranded Costs by Public Utilities and Transmitting Utilities, Order No. 888, 61 Fed. Reg. 21,540 (May 10, 1996), FERC Stats. & Regs. ¶ 31,036 (1996), *order on reh'g*, Order No. 888-A, 62 Fed. Reg. 12,274 (March 14, 1997), FERC Stats. & Regs. ¶ 31,048 (1997), *order on reh'g*, Order No. 888-B, 81 FERC ¶ 61,248 (1997), *order on reh'g*, Order No. 888-C, 82 FERC ¶ 61,046 (1998), *aff'd in relevant part, remanded in part on other grounds sub nom. Transmission Access Policy Study Group, et al. v. FERC*, 225 F.3d 667 (D.C. Cir. 2000), *aff'd sub nom. New York v. FERC*, 122 S. Ct. 1012 (2002).

Order No. 2000, issued in December 1999, encouraged all transmission owners to voluntarily place their transmission facilities in the hands of appropriate RTOs.[40] Order No. 2000 demonstrates FERC's philosophy that, in the longer term, the development of RTOs are superior to functional unbundling in creating independence and preventing undue discrimination. Moreover, FERC stated that there would be no need to enforce standards of conduct separating the transmission system operations and reliability functions and wholesale merchant functions to the extent that the RTO is independent of power marketing interests. In response to this order, APS has been a leader in the formation of the WestConnect RTO.

As discussed above, APS was one of the filing utilities requesting a declaratory order on the WestConnect RTO. On October 10, 2002, FERC, in response to the request for declaratory order, approved significant portions of the WestConnect RTO proposal. WestConnect has been developed to handle security, reservations, scheduling, transmission expansion, planning and congestion management for the Southwest regional transmission system in response to FERC's Order 2000. Its independent board structure will focus on ensuring reliability, nondiscriminatory open-access, and a robust wholesale market. The WestConnect Interim Committee, which APS is chairing, through the Seams Steering Group-Western Interconnection, is working with others in the West to resolve seams issues, which arise where different RTO markets interface.

Transfer of APS Generation to PWEC

As part of the restructuring envisioned by the 1999 Settlement, on July 28, 2000, APS submitted to FERC an application for authorization under Section 203 of the Federal Power Act to transfer all of its fossil and nuclear generation and associated FERC-jurisdictional facilities to PWEC. The filing noted that following the divestiture of generation assets to PWEC, "APS will become a 'wires' company, owning and operating transmission and distribution facilities." On November 24, 2000, FERC issued an order finding that the requested transfer of assets "will not adversely affect competition" and authorized the transaction.

FERC Code of Conduct

A public utility and its affiliates engaged in wholesale merchant functions must abide by FERC's code of conduct rules for market-based rates that govern the relationship between affiliated power marketers and the utilities that have captive ratepayers. The code of conduct rules prohibit the sharing of any wholesale market information by the public utility with captive ratepayers with any employees of the affiliated marketers unless that information simultaneously is made available to non-affiliated competitors. The purpose of the code of conduct is to prevent the transfer of benefits from the utility's ratepayers to stockholders

In compliance with FERC's requirements, APS initially was prohibited from transactions with marketing affiliates and had a Standard FERC Code of Conduct that restricted its relationship with its affiliate APSES. With the anticipated transfer of APS generation to PWEC and the establishment of a marketing and trading arm at Pinnacle West, however, there would be

[40] Regional Transmission Organizations, Order No. 2000, 65 Fed. Reg. 809 (January 6, 2000), FERC Stats. & Regs. ¶ 31,089 (1999), *order on reh'g*, Order No. 2000-A, 65 Fed. Reg. 12,088 (February 25, 2000), FERC Stats. & Regs ¶ 31,092 (2000), *petitions for review dismissed, Public Utility District No. 1 of Snohomish County, Washington v. FERC*, 272 F.3d 607 (D.C. Cir. 2001).

a need for the Pinnacle West companies to be able to transact business with each other. Therefore, on April 21, 2000, as part of the corporate restructuring envisioned by the 1999 Settlement, Pinnacle West filed with FERC on behalf of itself and its affiliates APS and APSES, an application under section 205 of the Federal Power Act, seeking, among other things: (1) authority for Pinnacle West to engage in wholesale sales of electric power at market-based rates, including market-based rate sales to its affiliates, including APS; (2) approval of revised market-based rate tariffs for APS and APSES to allow them to transact business with affiliates at market-based rates; and (3) approval of a code of conduct for PWCC and proposed modifications to the codes of conduct of APS and APSES that eliminated the provision requiring simultaneous disclosure to the public of all market information shared between APS and its marketing affiliates.[41]

With regard to APS' retail customers, the filing noted that a substantial portion of APS' retail customers were already authorized to choose their generation provider and that those customers not already authorized to make this choice would be eligible on January 1, 2001. In 2001, full retail choice became available and remains available to all retail customers in Arizona. Although all of APS' retail customers currently have choice, few customers have chosen to purchase their power supplies from alternative suppliers under current market conditions, choosing instead to remain with APS. However, it is the ability of retail customers to choose an alternate supplier and not whether they actually do so that is the basis for finding that such customers are protected from potential affiliate abuse

As to APS' captive wholesale customers, the companies proposed in their 2000 filing to protect these customers from potential affiliate abuse by capping APS' system incremental costs ("SIC") component at prices set by a competitive regional market hub (i.e., the Palo Verde Index) for customers with pricing provisions based on the SIC. Specifically, with regard to APS' wholesale power contracts that include a pricing provision based upon APS' system incremental costs, the companies mitigated any concerns regarding potential harm by capping the portions of these customers rates that include an SIC component at the lesser of: (i) the monthly rates calculated utilizing APS' actual hourly SIC values (the existing methodology); (ii) or the monthly rates calculated utilizing a regional market index in lieu of the actual SIC. APS' wholesale SIC contracts referenced in the filing terminated in 2001. Although APS still has a coordination tariff on file at FERC that has SIC provisions, no customers currently take service under that tariff. The companies also proposed similar protections for wholesale customers affected by a fuel adjustment clause.

In an order issued June 20, 2000 on this filing, FERC determined that APS' captive customers were adequately protected from affiliate abuse.[42] APS' retail customers were protected from potential affiliate abuse due to retail customers' ability to choose a supplier and by the rate reductions and limitations in effect. As for APS' captive wholesale customers, FERC determined that APS' captive customers were adequately protected from affiliate abuse by Pinnacle West's

[41] A similar filing was made subsequently on behalf of PWEC. *Pinnacle West Energy Corp.*, 92 FERC ¶ 61,248 (2000), *reh'g denied,* 95 FERC ¶ 61,301 (2001).

[42] *Pinnacle West Capital Corp.*, 91 FERC ¶ 61,290 (2000) ("June 20 Order"), *reh'g denied*, 95 FERC ¶ 61,300 (2001).

proposed safeguards for APS' customers with contracts using a SIC component and fuel adjustment clause.[43]

FERC Standards of Conduct

In Order No. 889,[44] issued concurrent with Order No. 888, FERC also imposed standards of conduct governing communications between the utility's transmission and wholesale power functions, to prevent a utility from giving its power marketing arm preferential access to transmission information. Under Order No. 889, all public utilities that own, control or operate facilities used in the transmission of electric energy in interstate commerce were required to create or participate in an OASIS that provides all existing and potential transmission customers the same access to transmission information to enable them to obtain open access non-discriminatory transmission service. The standards of conduct ensure that the public utility does not use its unique access to information unfairly to favor its own merchant functions, or those of its affiliates, in selling electric energy in interstate commerce. Accordingly, FERC requires that the public utility's employees engaged in transmission system operations must function independently from the public utility's employees and the employees of the affiliates who engage in wholesale merchant functions. Under the functional unbundling requirements, wholesale merchant function employees may not engage in transmission system operation or reliability functions.

In Order No. 889, FERC identified the original objectives of the Standards of Conduct to be: (1) to prohibit preferential access to information regarding transmission prices and availability to employees of wholesale merchant functions; (2) to ensure that employees in systems operations and reliability functions treat all customers fairly and impartially without preferential treatment of employees in wholesale merchant functions; and (3) to provide functional unbundling of transmission operations and wholesale merchant functions to allow impartial operation benefiting all. However, to avoid any compromise on reliability, FERC provided exemptions for emergencies. APS and its affiliates are in full compliance with the requirements of Order No. 889.

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[43] *Pinnacle West Capital Corp.*, 91 FERC ¶ 61,290 (2000), *reh'g denied*, 95 FERC ¶ 61,300 (2001); *see also Pinnacle West Energy Corp.*, 92 FERC ¶ 61,248 (2000), *reh'g denied*, 95 FERC ¶ 61,301 (2001). On December 30, 2002, GenWest, LLC, a subsidiary of PWEC that owns a generating facility outside of Las Vegas, Nevada, filed an application for market-based rates and for the same code of conduct waivers applicable to Pinnacle West, APS, PWEC and APSES. FERC staff requested GenWest to address whether the earlier code of conduct waivers were still warranted, and on April 10, 2003, GenWest filed an amended application addressing those issues. In a letter order issued June 6, 2003, in Docket No. ER03-352, FERC accepted for filing GenWest's market-based rates and the requested modified code of conduct.

[44] Open Access Same-Time Information System and Standards of Conduct, Order No. 889, FERC Stats. & Regs. ¶ 31,035 (1996); *order on reh'g*, Order No. 889-A, FERC Stats. & Regs. ¶ 31,049 (1997); *order on reh'g*, Order No. 889-B, FERC Stats. & Regs. ¶ 31,253 (1997); *order on reh'g*, Order No. 889-C, 82 FERC ¶ 61,046 (1998).

FERC Supply Margin Assessment ("SMA") Test

Traditionally, FERC allows power sales at market-based rates if the seller and its affiliates do not have, or have adequately mitigated, market power in generation and transmission and cannot erect other barriers to entry. FERC also considers whether there is a basis for concern that the grant of market rate authority will result in a reduced ability for regulators to monitor affiliate dealings to assure that there is no abuse. FERC has granted market-based rate authority to APS, Pinnacle West, PWEC and APSES based on such determinations.

In the SMA Order,[45] FERC outlined a new methodology to be used by applicants requesting market-based rate authority under Section 205 of the Federal Power Act. FERC also noted in the SMA Order that the SMA test is an interim method to be used until FERC adopts a new long-term methodology.

In non-ISO/RTO markets, the SMA test identifies whether the applicant is a pivotal supplier needed to meet peak load in the control area. Specifically, applicants are instructed to compare the applicant's generation capacity in the market to the difference between "Available Supply" and peak demand in the market (termed the "Supply Margin"). Available Supply includes all of the generating capacity located in the market, plus uncommitted capacity that can reach the market using available inbound transmission capacity, as measured by the Total Transfer Capability ("TTC") value. This capacity is then compared to peak load in the control area. If peak load can be met without the applicant's or its affiliates' capacity, then the applicant is not a pivotal supplier and the SMA test is passed. In markets where the applicant does not pass the SMA screen, FERC may condition or deny market-based rate authority.

Pinnacle West and its affiliates completed and recently submitted to FERC an analysis of the SMA test as applied to the control areas in which they own generation (APS, SRP and, in 2004, the Nevada Power control areas).[46] As described more fully below, the SMA test is easily passed in all markets. The results of the study showed there are no generation market power or other competitive concerns regarding continuing Pinnacle West's or its affiliate's market-based rate authority.

In the APS control area, both PWEC and APS own generating facilities physically located inside and outside of the APS control area. For purposes of the SMA test, all of the generation owned by these companies in the APS control area was included. The results show

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[45] *AEP Power Marketing, Inc., AEP Service Corporation, CSW Power Marketing, Inc., and Central and South West Services, Inc.; Entergy Services, Inc.; Southern Company Energy Marketing L.P.*, Order on Triennial Market Power Updates and Announcing New, Interim Generation Market Power Screen and Mitigation Policy, 97 FERC 61,219 (2001) ("SMA Order").

[46] Triennial SMA filing in FERC Docket Nos. ER99-4124-001, ER00-2268-003, ER00-3312-002 and ER99-4122,004, submitted April 10, 2003. A similar SMA screen was submitted earlier by GenWest, LLC, a PWEC subsidiary, for its Silverhawk facility, which is located outside of Las Vegas. That filing was made in connection with GenWest's application to sell at market rates. *See* FERC Docket No. ER03-352-000. As noted, GenWest's application for market-based rates, based on the SMA analysis of all of the Pinnacle West companies, was accepted on June 6, 2003.

that the amount of generation owned by these companies is much less than the Supply Margin for the APS control area, and therefore the SMA test is easily passed.

In the Salt River Project control area, both APS and PWEC own capacity. Once again, the analysis shows that the Supply Margin is greater than the capacity of APS and PWEC and the SMA test is passed. That is, APS and PWEC are not pivotal suppliers under the SMA test.

In the Nevada Power control area, the analysis was performed using a conservative estimate of the total capacity expected to be on-line during the summer 2004. As noted above, the SMA test also includes uncommitted generation outside of the control area, limited to the minimum of either the uncommitted generation or the TTC into the market. The Supply Margin is the difference between Available Supply and peak load. Because PWEC's capacity in this market consists only of only one facility (Silverhawk, owned by PWEC's subsidiary GenWest, LLC), the results of the analysis show that the Supply Margin is greater than the capacity of PWEC and the SMA test is passed.

Although the SMA test is intended to address generation market power, FERC also has expressed concern that an applicant might have transmission market power or be able to erect barriers to entry of new generation as a result of control over sites and fuels delivery systems. FERC typically has accepted an approved open access transmission tariff as demonstrating the requisite absence or mitigation of transmission market power. As additional support for its SMA filing, Pinnacle West and its affiliates provided information showing that they lack transmission market power as well. For example, APS, which owns transmission assets, has an open access transmission tariff on file with FERC. Further, APS is one of the filing utilities in support of the WestConnect RTO. Pinnacle West and its affiliates also provided information regarding substantial new entry in the relevant markets and surrounding control areas.

2. Corporate Governance Requirements

In evaluating compliance, the Commission must also consider the obligations of Pinnacle West and its subsidiaries, including APS, and their directors, officers, and employees to operate according to corporate governance standards established by state and federal law. Recently adopted statutory and regulatory requirements, most importantly the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), have re-emphasized the significance of corporate governance and impose stringent requirements on "public" companies (*i.e.*, companies that are required to file periodic reports and financial information with the SEC), such as Pinnacle West and APS, as well as their directors, officers, and employees. These requirements are in addition to those imposed by Arizona law. A common theme lies at the heart of each of these corporate governance requirements—every corporation must establish appropriate processes to effectively collect and publicly disclose material information to the corporation's investors or potential investors. Failure to do so can result in significant civil and criminal penalties.

Sarbanes-Oxley Requirements

Sarbanes-Oxley, enacted as a response to the failure of certain corporate executives to effectively police company activities, requires corporate executives to be fully informed about

the financial and operational condition of their corporations. The following summarizes several requirements of Sarbanes-Oxley.[47]

Certification of Financial Statements and Disclosure Controls and Procedures. Section 906 of Sarbanes-Oxley requires the CEO and CFO of APS and Pinnacle West to certify in every SEC periodic report containing financial statements that the filing fully complies with SEC requirements and that the information contained in the filing fairly presents, in all material respects, the financial results and operations of APS and Pinnacle West, respectively. A violation of Section 906 can result in a civil penalty of up to $5,000,000 and a prison term of up to 20 years. The CEO and the CFO depend on a free flow of information from APS, Pinnacle West, APSES, and Pinnacle West Energy to ensure the required levels of public disclosure necessary for the CEO and CFO to make the certifications.

Section 302 of Sarbanes-Oxley further requires the CEO and CFO of APS and Pinnacle West to certify in quarterly and annual SEC filings that (a) they have reviewed the filing; (b) to their knowledge, the filing does not contain any untrue statement or omission of material fact; (c) to their knowledge, the financial statements fairly present the company's financial condition and results; and (d) they have established and maintain appropriate "disclosure controls and procedures" (defined below) to ensure that material information relating to each company has been gathered and publicly disclosed. The CEO and CFO of APS and Pinnacle West must also include a separate report in each quarterly and annual SEC filing detailing their conclusions

[47] Sarbanes-Oxley imposes numerous additional responsibilities on public companies and their directors, officers, and employees. Since the July 30, 2002 effective date of Sarbanes-Oxley, Pinnacle West has completed numerous corporate governance initiatives, many well in advance of the compliance deadlines. These corporate governance initiatives, many of which formalized existing practices, include (a) the successful completion of the SEC's full review of Pinnacle West/APS SEC filings; (b) the adoption of Director Independence Standards; (c) formalization of periodic meetings of non-management directors; (d) the designation of a "Presiding Director" through whom interested parties may communicate with the non-management directors; (e) the establishment of a Corporate Governance Committee composed entirely of independent directors; (f) the adoption of a new Human Resources Committee Charter giving the committee additional authority and responsibility, consistent with New York Stock Exchange rule proposals; (g) the adoption of Corporate Governance Guidelines; (h) the determination of an "audit committee financial expert"; (i) the approval of a new Audit Committee Charter giving the committee additional authority and responsibility, consistent with Sarbanes-Oxley and New York Stock Exchange rule proposals; (j) implementation of Sarbanes-Oxley requirements that the Audit Committee retain and approve the compensation of the outside auditor and pre-approve the outside auditor's services; (k) implementation of a two-day "Section 16" insider trading reporting process, consistent with Sarbanes-Oxley; (l) early voluntary disclosure of off-balance sheet transactions in SEC filings; (m) early voluntary disclosure of "critical accounting policies" in SEC filings; (n) early voluntary compliance with new SEC rules regarding disclosure of pro forma financial information; and (o) expanded website disclosure (www.pinnaclewest.com), including (i) Section 16 Reports, (ii) SEC filings (i.e., Form 10-Qs, Form 10-Ks, and Form 8-Ks), (iii) charters of Audit Committee, Human Resources Committee, Corporate Governance Committee, and Operating and Finance Committee, and (iv) Pinnacle West's Corporate Governance Guidelines. Many of these corporate governance initiatives are discussed in detail in Pinnacle West's 2003 proxy statement, which is also available on its website. Based on a variety of corporate governance factors, as of June 11, 2003, Institutional Shareholder Services ("ISS") has assigned Pinnacle West a "Corporate Governance Quotient" that places Pinnacle West in the top quarter of all companies in the ISS utilities group.

about the effectiveness of each corporation's disclosure controls and procedures, which are defined as follows:

> [T]he term "disclosure controls and procedures" means controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Exchange Act is accumulated and communicated to the issuer's management, including its principal executive officer or officers and principal financial officer or officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.[48]

Code of Ethics. Section 406 of Sarbanes-Oxley requires APS and Pinnacle West to disclose whether they have a Code of Ethics applicable to the CEO, CFO, and principal accounting officer. Item 406 of SEC Regulation S-K, which implements Section 406 of Sarbanes-Oxley, requires that a qualifying Code of Ethics must be reasonably designed to deter wrongdoing and to promote:

- honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
- full, fair, accurate, timely and understandable disclosure in reports and documents that comply with SEC requirements;
- compliance with applicable governmental laws, rules and regulations;
- prompt internal reporting to an appropriate person identified in the code of violations of the code; and
- accountability of adherence to the code.[49]

Section 406 not only governs the conduct of the executives, but, as mentioned with respect to Sections 302 and 906 above, it requires adequate information so that the CEO, CFO, and others can ensure proper SEC disclosures. Section 406 references the necessity of prompt

[48] Rule 13a-14(c), Securities Exchange Act of 1934, as amended (the "Exchange Act") (emphasis added). Like many other public companies, APS and Pinnacle West have established a "Disclosure Review Committee" to promote effective disclosure controls and procedures. The Disclosure Review Committee consists of executive officers, accountants, auditors, and internal and external legal counsel and provides reports to the Audit Committee regarding, among other things, APS' and Pinnacle West's disclosure controls and procedures.

[49] Item 406(b) of Regulation S-K.

internal reporting of code violations, which further underscores the critical role of "disclosure controls and procedures." APS and Pinnacle West have implemented a Code of Ethics.[50]

Reporting of "Material Violations." Section 307 of Sarbanes-Oxley is an example of another legal requirement that mandates communications essential for effective corporate governance. Section 307 requires attorneys "practicing before the SEC" (for example, attorneys preparing APS' and Pinnacle West's SEC filings) who become aware of (a) evidence of a material violation of federal or state securities laws; (b) a breach of a fiduciary duty; or (c) a violation of similar laws, to report such breaches or violations to the company's Chief Legal Officer (or the CEO, if there is no Chief Legal Officer), the board of directors, or a special board committee. This reporting obligation of the attorney is often called "up the ladder" reporting because the attorney has an obligation to report the breach or violation up the ladder until the issue is responded to or resolved.

Arizona Law

Arizona law also imposes additional corporate governance requirements on APS' and Pinnacle West's officers and directors.[51] APS' and Pinnacle West's officers have a statutory

[50] The Ethics Policy and Standards of Business Practice (the "Code of Ethics") of Pinnacle West and its subsidiaries are detailed in a document entitled "Doing The Right Thing." The Code of Ethics covers all Pinnacle West, APS, PWEC and APSES employees, including each CEO, CFO, and principal accounting officer. The Code of Ethics, when combined with the disclosure controls and procedures discussed above, complies in all respects with Item 406(b) of Regulation S-K. Each employee is required to report Code of Ethics violations or suspected violations to the employee's immediate leader or to a hotline. The New York Stock Exchange has also proposed rule amendments that would require listed companies, like Pinnacle West, to have a Code of Business Conduct and Ethics for directors, officers, and employees, which must include the reporting of any illegal or unethical behavior (Proposed Listing Standard, Item 303A.10). The New York Stock Exchange has also proposed a requirement that New York Stock Exchange-listed companies, like Pinnacle West, must have corporate governance guidelines giving directors direct access to management (Proposed Listing Standard, Item 303A.9).

[51] Pinnacle West has established a corporate governance framework that assists the officers and directors of Pinnacle West and its subsidiaries in fulfilling their statutory obligations, as described in this section. Many aspects of this framework are described in footnote 47 above. With respect to officers, the standing committees of Pinnacle West's board of directors (described more fully in footnote 47), provide guidance to, and assess the performance of, officers and employees. The Human Resources Committee is responsible for identifying qualified individuals to serve as officers and reviewing the officers' performance. Similarly, the Audit Committee is responsible for the oversight of Pinnacle West's internal audit function and management's relationship with the independent auditor. The officers of Pinnacle West and its subsidiaries participate in quarterly leadership meetings, which include 200-250 leaders from throughout the organization. In addition to the operational issues addressed at these meetings, topics have included leadership principles; corporate values, including those embodied in the Code of Ethics; diversity; and legal developments. These quarterly leadership meetings are in addition to the quarterly meetings attended by all officers, the frequent officer staff meetings at which these and other issues are discussed, and the ongoing communication among officers regarding issues relating to the effective performance of their responsibilities. Pinnacle West also makes available to its management team, including its officers, formal leadership training provided by third parties, such as Arizona State University.

obligation to discharge their duties (a) in good faith; (b) with the care an ordinary prudent person in a like position would exercise under similar circumstances; and (c) in a manner the officers reasonably believe to be in the best interest of the corporation (A.R.S. § 10-842(A)). In discharging his or her duties, an officer is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by (i) one or more directors, officers or employees of the corporation whom the officer reasonably believes are reliable and competent in the matters presented; or (ii) legal counsel, public accountants, or other persons as to matters the officer reasonably believes are within the person's professional or expert competence (A.R.S. § 10-842(B)). As is the case with the Sarbanes-Oxley provisions discussed above, APS' and Pinnacle West's officers depend on communication from employees to fulfill these Arizona statutory obligations.

The legal obligations of directors fall into two broad categories: a duty of care and a duty of loyalty. The duty of care requires a director to act in good faith and on the basis of adequate information in arriving at business decisions. This duty of care is codified in the Arizona statutes, which place a statutory obligation on APS' and Pinnacle West's directors to manage the business and affairs of Pinnacle West (A.R.S. § 10-801) and to discharge their duties (a) in good faith; (b) with the care an ordinary prudent person in a like position would exercise under similar circumstances; and (c) in a manner the directors reasonably believe to be in the best interests of the corporation. (A.R.S. § 10-830(A)). Similar to officers, in discharging their duties directors are entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by (i) one or more officers or employees of the corporation whom the director reasonably believes are reliable and competent in the matters presented; (ii) legal counsel, public accountants, or other persons as to matters the director reasonably believes are within the person's professional or expert competence; or (iii) a committee of the board of which the director is not a member if the director reasonably believes the committee merits confidence (A.R.S. § 10-830(B)).

An important corollary to the statutory standard of conduct of directors set forth in A.R.S. § 10-830 (A) and (B) is the business judgment rule. The presumptions afforded by the business judgment rule are expressly recognized and preserved in the statute, which provides that a director is presumed in all cases to have acted, failed to act, or otherwise discharged such director's duties in accordance with the statute (A.R.S. § 10-830(D)). Although there is no relevant Arizona case law directly citing to any of the officer or director statutes mentioned

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With respect to directors, each standing board committee operates under a detailed charter designed to ensure that each committee member is qualified, informed and prepared to perform in accordance with the responsibilities specified the committee charter. The recently established Corporate Governance Committee not only identifies and evaluates qualified individuals to serve as directors, it is also responsible for developing corporate governance principles (set forth in Pinnacle West's Corporate Governance Guidelines) to establish director qualification standards, director responsibilities, director self-evaluation procedures, and policies and principles for CEO selection and performance review. These Corporate Governance Guidelines, which are posted on Pinnacle West's website, further require the board of directors to oversee Pinnacle West's compliance with its Code of Ethics, allow all directors full and free access to management, and make continuing education available to directors. Pinnacle West's board of directors is also frequently updated on current state and federal legal developments affecting their responsibilities.

herein, Arizona courts have provided interpretation of the duties associated with the business judgment rule.

APS' and Pinnacle West's directors are required to reasonably inform themselves in order to gain the protections offered to them by the business judgment rule. In *Resolution Trust Corp. v. Blasdell*,[52] the court stated that "the business judgment rule, stated generally, 'precludes judicial inquiry into actions taken by a director in good faith and in the exercise of honest judgment in the legitimate and lawful furtherance of corporate purpose.'" The court further described the business judgment rule by stating, "[t]he rule thus applies if directors act in furtherance of a legitimate corporate purpose, in good faith, and *after reasonably informing themselves*."[53] Further addressing this concept, the Arizona Court of Appeals stated that in order to "invoke the rule's protection directors have a *duty to inform themselves*, prior to making a business decision, *of all material information reasonably available to them*. Having been so informed, they must then act with the requisite care in the discharge of their duties."[54] The duty imposed on directors to reasonably inform themselves requires APS' and Pinnacle West's directors to maintain open lines of communication with employees, officers, and others within Pinnacle West and its subsidiaries.

The duty of loyalty also governs the conduct of APS' and Pinnacle West's directors. This duty of undivided and unqualified loyalty to the corporation for which they serve prohibits directors from (i) using their positions to profit personally at the expense of the corporation; (ii) usurping, for their own advantage, an opportunity that rightly belongs to the corporation; and (iii) entering into unfair transactions or contracts with the corporation. In *Phoenix Title and Trust Co. v. Alamos Land and Irrigation Co.*,[55] the Arizona Supreme Court stated that directors "must not in any degree...allow their official conduct to be swayed by their private interest, unless that interest is the interest which they have in the good of the company in common with all the other shareholders. This principle is asserted and illustrated by judicial decisions almost without number. This duty results from the nature of their employment, and without any stipulation to that effect. Their private interest must yield to their official duty whenever those interests are conflicting. They must neither exercise their trust for their own private exclusive benefit, nor for the benefit of third persons."[56] Any possible conflicts or potential breaches of this duty of loyalty must be communicated to officers, directors and others in order to resolve the conflict and protect the interests of the investors.

In today's business environment, corporate governance and the state and federal laws that apply to the conduct of the officers and directors of corporations are increasingly important. APS and its affiliates have been aggressive in implementing not just the letter but also the spirit embodied in Sarbanes-Oxley and other corporate governance laws. The directors and officers are

52 930 F. Supp. 417, 423 (D. Ariz. 1994).

53 *Id.* at 424 (emphasis added).

54 *Blumenthal v. Teets*, 155 Ariz. 123, 128 (Ariz. Ct. App. 1987) (emphasis added).

55 24 Ariz. 499, 507 (Ariz. 1922).

56 *Id.*

acutely aware of both their duties of loyalty and of the need to be informed of the business conduct of their company. The proactive actions undertaken by APS and its affiliates to meet all applicable corporate governance responsibilities have been both prudent and effective.

3. *Antitrust Laws*

The electric industry is subject to numerous federal and state antitrust laws affecting both the structure and behavior of industry companies. Specifically, several antitrust laws apply broadly to electric utilities in Arizona, although some are obviously limited under circumstances where the state has adopted a policy of regulated monopoly, such as for utility distribution service. These include:

- Section 1 of the Sherman Act, 15 U.S.C. § 1, which prohibits those contracts, combinations and conspiracies that unreasonably restrain trade;
- Section 2 of the Sherman Act, 15 U.S.C. § 2, which proscribes monopolization and attempts to monopolize;
- the Arizona Uniform Antitrust Act, A.R.S. §§ 44-1401, *et seq.*, which substantially follows the proscriptions of the Sherman Act; and
- the Federal Trade Commission Act, 15 U.S.C. § 45(a), which applies to unfair and deceptive acts and practices as well as providing authority to the Federal Trade Commission ("FTC") also to enforce the federal antitrust laws, other than the criminal provisions, which are enforced solely by the U.S. Department of Justice Antitrust Division.

The Sherman Act has long been applied to the electric industry, with respect both to challenges concerning agreements among electric utilities,[57] and concerning monopolization issues, such as access to transmission lines,[58] and alleged anticompetitive attempts to leverage a utility's position in one market into a second, unregulated, market.[59] Additionally, the Clayton Act and Robinson-Patman Act have been held to apply to the electric industry.[60]

It is important to recognize that the antitrust laws are intended to protect the competitive process. As the United States Supreme Court repeatedly has observed, the purpose of the antitrust laws is "to protect competition, not competitors."[61] Antitrust analysis thus focuses on

[57] *See, e.g., United States v. Rochester Gas & Electric Co.*, 4 F. Supp 2d 172 (W.D.N.Y. 1998); *Gainesville Utilities Dep't v. Florida Power & Light Co.*, 573 F.2d 292 (5th Cir. 1978).

[58] *See, e.g., Otter Tail Power Co. v. United States*, 410 U.S. 366 (1973); *City of Chanute v. Kansas Gas & Electric Co.*, 754 F.2d 310 (10th Cir. 1985).

[59] *See, e.g., Yeager's Fuel, Inc. v. Pennsylvania Power & Light Co.*, 953 F. Supp. 617 (E.D. Pa. 1997).

[60] *See, e.g., City of Kirkwood v. Union Electric Co.*, 671 F.2d 1173 (8th Cir. 1982), *cert. denied*, 459 U.S. 1170 (1983) (applying Robinson-Patman Act).

[61] *Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.*, 429 U.S. 477, 488 (1977).

whether a particular corporate structure or practice enhances economic efficiency, and thereby enhances consumer welfare.

Consequently, the antitrust laws do not condemn vertical integration, or business dealings among corporate affiliates of vertically-integrated companies, such as electric utilities. On the contrary, such vertical integration is considered, from an antitrust perspective, as efficiency-enhancing and thus contributing to consumer welfare, through reduction of production and transaction costs. As the leading antitrust law treatise concludes:

> Vertical integration can produce significant cost reductions by enabling the integrating firm to achieve two kinds of efficiencies. "Production" efficiencies . . . and "transactional" efficiencies . . . .
>
> In speaking of the evils of vertical integration, courts sometimes identify the harm as "unfair" advantage" over unintegrated rivals. But in most cases the only advantage at issue is the integrating firm's ability to reduce its cost below that of unintegrated firms.[62]

To protect these efficiencies, which further the purpose of the antitrust laws to enhance consumer welfare, courts have rejected antitrust challenges to vertically-integrated firms' coordination of activities among their affiliates, even where the result is to injure a rival firm.[63]

Thus, *no* coordination between APS, Pinnacle West and PWEC regarding electric industry restructuring in Arizona would violate any applicable antitrust law. For example, PWEC presenting a business assumption regarding the anticipated transfer of APS generation to acquire a contingent investment grade credit rating would not violate any antitrust law. To impose restrictions on communications or coordination of activities among an electric utility's affiliates would simply sacrifice efficiencies, raise the costs of the incumbent utilities, and subsidize other less efficient firms, all to the detriment of consumers and the competitive process.[64] None of APS' actions nor those of its affiliates have violated any applicable antitrust laws and no party has accused APS or an affiliate of such a violation. Further, antitrust issues based on monopolization or attempt to monopolize are of no concern in this instance, because APS and its affiliates all pass FERC's Supply Margin Assessment screen regarding potential market power held by electric utilities.

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[62] IIIA P. AREEDA & H. HOVENKAMP, ANTITRUST LAW ¶ 757a at 23 (2d ed. 2002).

[63] *See, e.g., Berkey Photo v. Eastman Kodak Co.*, 603 F.2d 263 (2d Cir. 1979), *cert. denied*, 444 U.S. 1093 (1980); *Grason Electric Co. v. Sacramento Municipal Utility District*, 571 F. Supp. 1504, 1528-29 (E.D. Cal. 1983).

[64] For a detailed discussion of the legal and economic concerns regarding imposition of such restrictions, *see* C.O. Hobbs, S.P. Mahinka and T.A. Gebhard, *State Marketing Restrictions on Electric Utilities: Analysis of the Adverse Effects on Competition from Competitive Handicapping* (Edison Electric Institute Monograph, Sept. 1997).

V. RESPONSES TO SPECIFIC ASSERTIONS

A. Formation of PWEC and Construction of Units

During the hearing on the APS Financing Application, various parties questioned the formation of PWEC and its reasons for constructing new generation in Arizona. Those questions appeared to give rise to some concern on the part of the Chief Administrative Law Judge and the Commission. Yet, when the actions of APS and PWEC are reviewed in light of the history of the energy market in Arizona and the West, as discussed above, it becomes clear that both APS and PWEC acted consistent with Commission guidance and requirements, and took appropriate steps to protect APS' customers. By dedicating its capacity to APS customers, PWEC prevented APS from falling victim to the rush into high-priced, long-term contracts that occurred in California, Nevada and other states in the Western United States. In no small measure, it was PWEC's and Pinnacle West's actions that allowed APS to weather the Western power crisis.

PWEC was formed to implement the Commission's generation divestiture requirement. In approving the 1999 Settlement, the Commission stated that it "supported" the transfer of all of APS' generation to a Pinnacle West subsidiary, and that sales to APS by that subsidiary at market-based rates were in the public interest, would not violate Arizona law, would not give the affiliate an undue competitive advantage, and would benefit customers.

Rule 1615 as finally enacted required the divestiture of all APS generation assets (as well as other competitive services) to an unaffiliated party or a separate corporate affiliate prior to January 1, 2001.[65] In the 1999 Settlement and Decision No. 61973 approving the 1999 Settlement, the Commission approved the transfer of APS' generating assets to a separate affiliate of APS (PWEC) but extended the transfer date to the end of 2002. In the decision approving the Settlement, the Commission specifically concluded that it "*supports and authorizes* the transfer by APS *to an affiliate* or affiliates *all* of its generation..."[66] Further, in the Settlement the Commission also agreed that allowing APS' generation to be owned by an affiliate would (1) "benefit consumers," (2) was "in the public interest," and (3) "does not violate Arizona law." And, the Commission also acknowledged that APS would purchase energy from that affiliate, and such purchases (1) "will benefit consumers and...not violate Arizona law," (2) would not provide APS' affiliate with "an unfair competitive advantage by virtue of its affiliation with APS," and (3) that such transactions were "in the public interest."[67]

Thus, in response to the Commission's requirements, PWEC was created for the purpose of and with the expectation that it would receive and own all of APS' generation assets. Under both the Electric Competition Rules and APS' Code of Conduct, APS was not permitted to

65 A.A.C. R14-2-1615(A).

66 Decision No. 61973 at 10 (emphasis added).

67 *Id.*, Attachment 1 at 6-7.

construct new generation.[68] Moreover, because only prudent costs associated with transferring APS generation to PWEC were recoverable, there would certainly have been a challenge to the recovery of transfer costs associated with new generation when APS knew that it was required to transfer all of its generation to PWEC by the end of 2002. Thus, in addition, PWEC was intended to help ensure that APS and APS customers had access to necessary generation resources.

After its formation, and in response to APS' rapidly growing customer demand, PWEC set out to construct or purchase generation in locations designed to ensure that APS' energy needs would be met. By the late 1990s, there was significant growth in demand for power both in the region and specifically among APS customers. Growth in the Valley was especially pronounced. APS' analyses were showing that APS would reach a generation deficit of 2200 MW by 2007 and that other utilities in the Southwest were increasingly short of generating capacity. Also, in 1998 and 1999, the surge in merchant generation construction in Arizona had yet to occur.

Because APS' Code of Conduct and the Electric Competition Rules prohibited APS from constructing new generation after the 1999 Settlement, PWEC constructed both temporary and long-term capacity to benefit APS customers. In large part, this new capacity spared APS from entering into high-priced long-term contracts like other Western utilities during the 2000-2001 energy crisis.

The plans for PWEC's construction of both Redhawk and West Phoenix 4 and 5 were publicly announced and well-known to the Commission. In fact, APS identified Redhawk and expansions at Saguaro and West Phoenix as necessary and planned resources to the Commission during a summer preparedness hearing in early 2001.[69] No merchant generator nor any other party raised any objections to those goals as stated at the time they were announced. PWEC commenced its construction program in response to the then existing and anticipated dramatic capacity shortages being experienced in the state and the Western United States.[70]

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[68] Specifically, Section X(B) of APS' Code of Conduct prohibits APS from engaging in "Interim Competitive Activities," which is defined as "Competitive Services, exclusive of those set forth in Rule 1615(B), that APS may lawfully provide until December 31, 2002." In the Financing Application, certain parties contended that constructing new generation was not a "Competitive Service" because it would serve non-competitive Standard Offer customers. That assertion is refuted by the Concise Explanatory Statement that accompanied the final Electric Competition Rules, which explained that it is "clear that competitive generation includes all generation except for Must-Run Generating Units." The 1999 Settlement also required the divestiture of *all* generating units. Having fought over the divestiture requirements for two years, it would have been unreasonable and futile for APS to have sought authorization to construct the PWEC generation just months after both the 1999 Settlement and the final Electric Competition Rules were approved by the Commission.

[69] APS Presentation at Commission's Energy Workshop, February 16, 2001.

[70] Additional detail regarding both the development and construction of the PWEC generation units will be provided in the rate case filing that APS will submit to the Commission.

Although California experienced rolling blackouts and both California and Nevada entered into long-term contracts that they are now attempting to terminate, APS was able to weather the storm due in large part to the efforts undertaken by PWEC. Instead of forcing APS to look to the unstable wholesale market, PWEC undertook a multi-pronged approach to assist APS in meeting its energy needs. First, PWEC specifically looked for opportunities to construct new generation within APS' well-known Metro Phoenix load pocket and subsequently announced the construction of West Phoenix CC4 and CC5. Moreover, when it became apparent that Arizona could experience during the summer of 2001 the shortages already being experienced in California and Nevada, PWEC accelerated the completion of West Phoenix CC4 and located 198 MW of temporary, trailer-mounted generation at the West Phoenix and Saguaro plants to ensure reliability for APS' customers.[71] Finally, to ensure that APS' needs would be met in 2002, PWEC also accelerated the in-service date of Redhawk Units 1 and 2 from 2003/2004 to 2002.[72]

The all-too-recent past in California and Nevada makes reliability a continuing concern of APS and there are significant future challenges already on the horizon. The competitive wholesale market continues to be challenging, exhibiting significant volatility. Little additional generation is planned and more plants are being cancelled or delayed, despite continued load growth throughout the Western United States. And, financing for new power plant construction remains largely unavailable. These facts suggest that, in the future, unexpected increases in demand could be met with insufficient supply. Further, there is continuing uncertainty regarding wholesale market design, credit quality concerns amongst counter-parties, and continuing challenges to wholesale power contracts at FERC and elsewhere. In APS' case, the relatively poor response of merchant generators in the recently-completed Track B competitive solicitation highlights these concerns.

B. PWEC Financing

Decision No. 65796 alleges that "PWEC made presentations to rating agencies indicating that PWEC was under contract to sell its output to APS under a four-year purchase power agreement." That decision also referred to a provision in Decision No. 61973 that APS not "subsidize the spun-off competitive assets through an unfair financial arrangement" and appears to suggest that this provision is implicated somehow in the PWEC financing arrangements.

The financing arrangements for the PWEC units did not violate either the letter or spirit of the Electric Competition Rules, Decision No. 61973, the APS Code of Conduct, or any applicable law. And, there was no misrepresentation made to the ratings agencies regarding any arrangement between APS and PWEC regarding future power sales or regarding the

[71] At the same time, APS re-commissioned two steamer units (4 and 6) at the West Phoenix Power Plant. Without those APS steamer units, PWEC's West Phoenix CC4, and the temporary units brought in by PWEC, APS could have faced serious capacity shortages during the summer of 2001.

[72] PWEC also pursued a variety of partnerships and purchase options in order to obtain capacity to meet Arizona's rapidly growing demands. For example, as explained during the hearing on the Financing Application, PWEC pursued options for joint construction with both Calpine and Reliant. In addition, purchases from Southern California Edison and El Paso Electric of shares in existing units were considered. As it became clear that none of those options would come to fruition, PWEC focused its efforts on constructing generation to meet Arizona's needs.

requirements of the Electric Competition Rules and 1999 Settlement. Rather, these financing activities were a logical and sensible response to the Commission's divestiture requirements in the Electric Competition Rules and the 1999 Settlement and were conducted in a straightforward and professional manner.

First, the decision of how to finance the construction of the PWEC units was based on the circumstances existing at the time the decision was made. In late 1999 and early 2000, everyone expected that APS would be divesting all of its generation assets to PWEC as required by Decision No. 61973 and the APS Settlement. With that assumption, and considering the relatively short three-year time horizon over which that divestiture was supposed to occur, the most economical and least complex and restrictive approach to financing was to issue short-dated parent debt that would come due shortly after the anticipated divestiture was completed. Then, once the assets were transferred, PWEC would be able to take advantage of its investment grade credit ratings, and access the debt capital markets at a lower cost than if it had issued long-term debt without the investment grade ratings. This subsequent debt would be of a longer maturity, reflecting the long-lived nature of the assets being financed.

Additionally, the construction of the PWEC units, including the fact that the units were being constructed in APS' service territory, was very public. The Arizona Power Plant and Transmission Line Siting Committee and the Commission approved Certificates of Environmental Compatibility for the units in 2000. The units were discussed during APS' summer preparedness hearings at the Commission and in conversations with the Governor. And, the decision to issue bridge debt to finance the PWEC assets was disclosed in numerous public filings.[73] Under Arizona law, neither Pinnacle West nor PWEC were required to obtain Commission approval to issue debt or obtain financing to construct the units.[74]

The contingent credit ratings obtained by PWEC, which were investment grade ratings contingent on PWEC actually acquiring the APS generation as promised in the 1999 Settlement, were not inconsistent with the discussion in Decision No. 61973 regarding the financing arrangements of the spun-off APS generation. That decision stated:

> Some parties were concerned that Section 4.1 and 4.2 [of the APS Settlement] provide in effect that the Commission will have approved in advance any

[73] *See, e.g.,* Pinnacle West's 1999 Form 10-K under GENERATION EXPANSION: "Pinnacle West Energy's capital expenditures will be funded with debt proceeds, and internally-generated cash and debt proceeds from the parent company"; Pinnacle West's 2000 Form 10-K under GENERATION EXPANSION: "Pinnacle West Energy's expenditures are expected to be funded through internally-generated cash and debt issued directly by Pinnacle West Energy, as well as capital infusions from Pinnacle West's internally generated cash and debt proceeds"; Pinnacle West's 2001 Form 10-K under GENERATION EXPANSION: "Pinnacle West Energy is currently funding its capital requirements through capital infusions from Pinnacle West, which finances those infusions through debt financings and internally-generated cash."

[74] A.R.S. § 40-301 and A.R.S. § 40-302 both apply only APS and APSES. Because the financing of the PWEC assets did not involve APS, neither A.A.C. R14-2-804 nor any of the other Affiliated Interest Rules nor the APS Code of Conduct were implicated by these actions.

> proposed financing arrangements associated with future transfers of "competitive services" assets to an affiliate....We share the concerns that the non-competitive portion of APS not subsidize the spun-off competitive assets through an unfair financial arrangement. We want to make it clear that the Commission will closely scrutinize the capital structure of APS at its 2004 rate case and make any necessary adjustments.[75]

The potential concern addressed in Decision No. 61973 and the financing arrangements made by PWEC are completely different and wholly unrelated issues. In the hearings and during the briefing of the APS Settlement, some parties had expressed concerns that the transfer of the APS generation, which would require some division of debt and equity within APS as the APS generation is both debt and equity financed, could affect the capital structure of APS in a manner detrimental to customers.[76] For example, Enron noted in its post-hearing brief that debt financing was less expensive than equity financing and is tax deductible. Thus, Enron's concern was that the APS generation could be transferred using a highly-leveraged structure, which would lower the cost of capital to PWEC and "shift the higher cost of capital (equity) to the regulated company."[77] Thus, the decision contained the language regarding the scrutiny that would be given in the 2004 rate case to ensure that such subsidization fom the capital structure of any transfer did not occur.

The financing arrangements made by PWEC do not raise this concern for several reasons. First, APS could not "subsidize" the financing of the PWEC units because APS was not financing them at all. The debt and equity associated with the PWEC units was held at Pinnacle West and was intended to be held at PWEC post-divestiture. Second, seeking a contingent investment-grade credit rating based on a business assumption that the 1999 Settlement actually would be implemented is hardly subsidization. The Commission had already ordered APS to divest *all* of its generation to PWEC. For PWEC to plan its business model on this assumption is both rational and to have been expected. And, the Commission in the Settlement had expressly agreed that PWEC "will be subject to regulation by the Commission, to the extent otherwise permitted by law, to no greater manner or extent than the manner and extent of Commission regulation imposed upon other owners or operators of generating facilities."[78] No other generating company could have been prohibited from presenting assumptions to the rating agencies that it was planning to receive future assets pursuant to an agreement requiring their transfer and that the receipt of such assets should be considered when issuing the ratings for periods following that transfer.

In preparing the rating agency presentation for PWEC's initial credit ratings, Pinnacle West and PWEC followed standard industry practices. This included the hiring of independent market consultants (PA Consulting) and independent engineers (Stone and Webster). The two

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75 Decision No. 61973 at 10.

76 *See* Enron Post-Hearing Brief, Docket E-01345A-98-0473, et al., at 13-14 (August 5, 1999).

77 *Id.* at 14.

78 Decision No. 61973, adopting Section 4.4 of the 1999 Settlement.

parties were hired in August 2000 and worked for approximately six months developing market forecasts (PA Consulting) and performing in-depth reviews of all of the power plants.

The presentation book given to the rating agencies reflected the PA Consulting and Stone and Webster forecasts, as well as Pinnacle West's assumptions including:

- the transfer to PWEC of APS' fossil generation assets in January of 2001 and APS nuclear generation assets by the end of 2002;
- PWEC generation additions of Redhawk units 1, 2, 3, and 4 (2,026 MW total), West Phoenix units 4 and 5 (631 MW total), and the purchase of 72 MW from Nevada Power Company at the Harry Allen plant in Nevada;
- that, post-divestiture, PWEC generation would be dedicated to native load requirements through a transfer pricing agreement ending in 2004 in conformance with Rule 1606(B) or, if deemed necessary, a variance to that rule.

Given the circumstances at the time, Pinnacle West believed these all to be reasonable assumptions. However, it is clearly the last assumption that has caused the most confusion in Decision No. 65796.

As noted above, there was an assumption made for purposes of financial modeling that a purchase power agreement would be used to serve APS' needs through 2004. Under this assumption, for 2001 and 2002 PWEC would supply that generation through a contract with Pinnacle West Marketing and Trading, which in turn would resell the power to APS at a market price. This period was prior to when the competitive bidding requirement in Rule 1606(B) would become effective. For 2003 and 2004, the assumption was that PWEC would continue to sell all of its power to Pinnacle West Marketing and Trading. Pinnacle West Marketing and Trading would provide power to APS at market prices but up to 50 percent of APS' power could be supplied through the competitive bidding process in the Electric Competition Rules.[79]

Thus, under this model, PWEC would sell *all* of its power to Pinnacle West Marketing and Trading and APS would procure *all* of its needs at market prices, including the possibility of 50 percent coming through competitive bidding.[80] It was reasonable to assume that a significant amount of APS' power would be supplied by the fuel-diverse fleet of generation that was being divested by APS pursuant to the Electric Competition Rules. Also, there was no reason for APS to believe that a contract at market prices would not have been considered an "arm's length" transaction. There was, however, never a representation made to the rating agencies that PWEC actually had a signed contract with APS through 2004, or that APS would contract with PWEC in some manner that violated the Electric Competition Rules. Neither was there any representation made that the Commission had approved such an agreement.

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[79] *See. e.g.,* PWEC Rating Agency Presentation (February 2001) at p. 12 (specifically referring to the 50 percent competitive bidding requirement in the Electric Competition Rules). This presentation was Panda-TECO Exhibit No. 23 in the proceeding on the Financing Application.

[80] The full output contract between PWEC and Pinnacle West Marketing and Trading for the PWEC generation would have remained in effect regardless of whether APS was being supplied by other parties under the competitive bidding requirement in the Electric Competition Rules.

Executives from Pinnacle West met with the rating agencies to review the presentation book. After the initial meeting, each of the rating agencies followed up with requests for various scenarios "stress testing" the forecasts. Each of the three agencies used its own assumptions in addition to those modeled by PA Consulting, Stone and Webster, and Pinnacle West. Had the rating agencies felt that any of the assumptions were unrealistic, they presumably would have modeled it differently and the financial modeling was, after all, ultimately their responsibility. And, the rating agencies were specifically provided with copies of the Electric Competition Rules and the 1999 Settlement.

After their analysis, contingent investment grade credit ratings were deemed appropriate by each of the rating agencies based on credit metrics for a 20-year horizon. The agencies looked at the minimum fixed charge coverage ratio ("FCCR") as well as the average over that 20-year period. They looked at the FCCRs in the base case that was presented as well as the various stress scenarios. Even had the purchase power agreement modeled in the base case been above or below market, because of its relatively short term of four years, it would have had a minimal impact in evaluating the entire 20-year horizon studied by the agencies.

Later in 2001, the electric utility industry started to experience the difficulties centered around Enron and other merchant generating companies. The bank and debt capital markets became extremely sensitive to any complication in a company's credit picture. Pinnacle West's bankers had been kept apprised of the planned divestiture of the APS generation and the then-planned phased-in approach of first transferring the fossil units and then the nuclear units by the end of 2002. Pinnacle West realized in the fall of 2001 that a transfer of the fossil assets might not occur that year given the recent crisis in California. However, by this time, project financing options were no longer available for Pinnacle West or PWEC, just as they were not for the vast majority of the industry. The Commission initiated its inquiry into the Electric Competition Rules in 2002 and halted the planned divestiture of the APS generation to PWEC, thus rendering the contingent credit ratings moot.

C. APS' Power Procurement

During the hearing on APS' Financing Application there also appeared to be questions raised regarding APS' power procurement. This resulted in an assertion that the "dedication" of the PWEC units to APS' customers "raises the issue of possible intended noncompliance with the Commission's [Electric Competition Rules] and/or possible anticompetitive activity."[81] This general statement is not further clarified nor are any specific legal requirements referenced. Neither allegation is correct. APS never violated, or intended to violate, Rule 1606(B). Nor has either APS or PWEC engaged in "anticompetitive activity" in developing a business strategy designed to protect its customers and shareholders.

No Electric Competition Rule that applied to APS prior to January 1, 2003 required *any* specific action by APS regarding power procurement or limited its options, other than self-building new generation. Under Decision No. 61973, the procurement requirements of Rule 1606(B) were delayed for two-years until the beginning of 2003 so that any procurement

[81] Decision No. 65796 at 34, n.18.

activities by APS were not restricted by that rule through the end of 2002. As discussed above, the only interim provision relating to Rule 1606(B) addressed the *supply* of generation from APS (and provided that APS would not discount generation for Standard Offer customers) not the *procurement* of generation by APS. And, because APS' rates were capped during this interim period (and in fact through mid-2004), none of APS' procurement activities could have harmed APS' captive customers because they paid the same amount to APS regardless of where APS' power was obtained.[82] All procurement of Standard Offer supplies between APS and its affiliates occurred lawfully under FERC-approved market-based rate tariffs.

With respect to post-2002 compliance with Rule 1606(B), APS had filed its Request for Partial Variance in October 2001 *requesting* a variance to that rule pursuant to Rule 1614. That request was a lawful and expressly permitted filing based on the belief that customers would be better off under APS' proposal. Any suggestion that a request for a variance believed to be in the public interest shows "possible intended non-compliance" would unlawfully gut the ability of any utility to file for any variance on any rule. Regardless, in April 2002 APS made it clear that if the Commission denied its application the Company would proceed with "good faith compliance with Rule 1606(B) as written."[83] Ultimately, however, the Commission concluded—as APS had argued—that the "wholesale market is not currently workably competitive; therefore, reliance on that market without recognizing its current uncertainty and limitations will not result in just and reasonable rates for captive customers."[84] As a result, the Commission itself decided that Rule 1606(B) needed to be stayed. Thus, the Commission reached *the same conclusion* regarding Rule 1606(B) that APS had argued in its Request for Partial Variance, but chose a different means of addressing that conclusion.

APS never stated that it would refuse to comply with any lawful Commission order. Thus, in the Partial Variance proceeding, APS specifically stated that if the Commission denied the Company's application, APS would proceed with "good faith compliance with Rule 1606(B) as written."

Also, because the Commission had already approved sales from PWEC to APS as in the public interest in the 1999 Settlement, the dedication of the PWEC units to APS' customers is not evidence of "possible intended non-compliance" with the Electric Competition Rules. Under those rules, APS was still required to provide reliable service at just and reasonable rates even after it was required to divest its generation pursuant to Rule 1615(A). APS had significant exposure to a dysfunctional wholesale market because its load was increasingly exceeding the Company's owned generation. Because APS could not itself build generation, Pinnacle West and PWEC constructed the PWEC units to fill the gap left in the Electric Competition Rules regarding the obligation to serve. PWEC installed expensive temporary capacity in APS' service

82 *See Pinnacle West Capital Corp.*, 91 FERC ¶ 61,290 (2000), *reh'g denied*, 95 FERC ¶ 61,300 (2001).

83 *See* APS' April 19, 2002 Motion for Threshold Determination, Docket No. E-00000A-02-0051, et al., at 3.

84 Decision No. 65154 at 29.

area during the summer of 2001 to maintain reliability during an extremely challenging period in Western United States power markets. And, PWEC (and not APS) voluntarily refrained from selling its newly-constructed units forward into other wholesale markets at lucrative prices because of their dedication to ensure that APS' customer needs were met.

The construction of the PWEC units proved to be extremely advantageous for APS customers. In California, the turmoil of two years of skyrocketing wholesale power costs forced CDWR to buy more than $40 billion in long-term contracts to stabilize California's exposure to the market. The state is now trying to litigate its way out of those contracts. In Arizona, APS was not forced to buy high-priced, long-term capacity because the PWEC units were available to APS customers. Indeed, the results of the recently completed Track B process established that without the PWEC "dedicated" capacity, APS would not be able to reasonably meet its summer requirements in the next few years.

Nothing prohibited other merchant generators that constructed capacity in Arizona from announcing that their capacity was "dedicated" to APS customers. In fact, many took the historically undocumented position during the Track B proceeding that they wanted to serve and had planned on serving APS load. The results of the Track B competitive procurement and the participation of merchant generators in that proceeding demonstrate, however, that none of the merchant generators were willing to assume the risks that PWEC and Pinnacle West assumed in holding back their generation to benefit APS customers.

D. Other Assertions

During the hearing on the APS Financing Application and in Decision No. 65796, certain other issues were raised. The Commission expressed concern about the possible use by Pinnacle West or PWEC of APS generation and captive ratepayers to gain an advantage in the developing competitive environment. The Decision also questioned why APS, rather than PWEC, applied for an air quality permit for the PWEC West Phoenix and Saguaro plants. And, the Chief Administrative Law Judge inquired about how the requirement in Decision No. 61973 that the supply of generation during the two-year extension to Rule 1615 and Rule 1606(B) was addressed in APS' Code of Conduct to ensure that APS did not obtain any advantage over ESPs in retail competition. The latter issue was discussed above in Section IV(B). The two former issues are discussed below.

Pinnacle West Use of APS Generation

PWEC made no "inappropriate" use of the APS assets that either harmed customers, violated the law, or was inconsistent with the 1999 Settlement. In fact, the 1999 Settlement required APS to divest all of its generation to PWEC. Under that requirement, the generation would become subject only to FERC regulation and, to the extent applicable, the Commission's Affiliated Interest Rules. The 1999 Settlement also contained a specific acknowledgement that the generation affiliate formed under Pinnacle West to receive the APS generation would be subject to no more regulation by the Commission than other non-utility owners of generation.[85]

[85] 1999 Settlement at § 4.4.

Given the contractual commitment obtained by APS authorizing the transfer of generation to PWEC, it was entirely appropriate for PWEC to develop a business plan that assumed it would acquire the APS generation assets. There is no Commission regulation or any state or federal law that would prohibit PWEC from making such an assumption, or taking action based on that contractual commitment. Thus, it was appropriate for PWEC to ask the credit rating agencies who were evaluating PWEC post-divestiture to look at how the APS generation would affect its credit rating, and obtain a more favorable rating based on PWEC obtaining such generation that would otherwise be available for the PWEC units on a standalone basis.

There is no Commission regulation or order, or any state or federal law, that would prohibit PWEC from assuming that it would receive the APS generation as required by the 1999 Settlement. In fact, that was the only logical assumption that could PWEC could have made in developing and presenting its business plan.

Likewise, the regulatory body with jurisdiction over wholesale sales has concluded that APS' captive customers were protected and authorized Pinnacle West and its affiliates to sell to each other at market-based rates. Section 4.4 of the 1999 Settlement included specific Commission findings that such sales would benefit consumers, did not violate Arizona law, would not provide APS' generation affiliate with an unfair competitive advantage, and were in the public interest. Moreover, APS' retail rates cannot be increased prior to mid-2004 so there is no way for APS to recover more or less from customers regardless of what actions it takes with Pinnacle West or PWEC prior to that time. Thus, neither PWEC nor Pinnacle West could or have used APS generation in any way to adversely affect captive customers or unfairly compete in the developing wholesale market.

Air Quality Permits

Under the Maricopa and Pinal County air regulatory programs, no person may commence construction or operation of a source of air emissions until the person has obtained any required air permit.[86] A "source" is defined as any "building, structure, facility or installation" that causes or contributes to air pollution.[87] In turn, a "building, structure, facility or installation" is defined as all of the pollutant-emitting activities which (1) belong to the same industrial grouping; (2) are located on one or more contiguous or adjacent properties; and (3) are under common control.[88] Thus, under applicable law, one permit is required for each source.

The United States Environmental Protection Agency ("EPA") has issued a number of interpretive letters and guidance documents addressing when facilities located on contiguous or

[86] *See* Maricopa County Environmental Services Department ("MCESD") Rule 200 § 302; Pinal County Air Quality Control District ("PCAQCD") Rule § 3-1-040.A.

[87] *See* MCESD Rule 100 § 200.99; PCAQCD Rule § 1-3-140.123.

[88] *See* MCESD Rule 100 § 200.26; PCAQCD Rule § 1-3-140.21.

adjacent property constitute one source for air permitting purposes.[89] In these documents, EPA has expressly stated that common control is established through common ownership, meaning a common parent company.[90]

EPA regulations required APS to apply for the air permits for PWEC's West Phoenix and Saguaro plant expansions. PWEC paid APS for all costs associated with these permit applications.

At both the West Phoenix and Saguaro Power Plants, PWEC constructed facilities at locations where APS owned existing generation. Because APS and PWEC are under common control—they are both owned by Pinnacle West—and the facilities belong to the same industrial grouping and are located on adjacent properties, the APS and PWEC units at each site constitute one "source" under applicable law. The air quality regulatory requirements relating to the APS and PWEC units are required to be included in one air permit. Because APS was, and still is, the operator of the facilities, and already held the permit for the West Phoenix and Saguaro Power Plants, APS was required to apply for the amended air permit to add the PWEC units. PWEC, however, paid all costs associated with obtaining the amended air permits at both plants.

An analogous situation exists at the Cholla Power Plant. At that plant, APS both applied for and holds the air permit for all four units, even though Unit 4 is owned entirely by PacifiCorp. In that situation, "common control" exists due to the contractual relationship between APS and Pacificorp, which delegates to APS the authority to operate the plant.

[89] *See, e.g.*, Nov. 27, 1996 letter to Jennifer Schlosstein, Simpson Paper Company, from Matt Haber, EPA Region IX; Nov. 2, 1995 letter to Terry Harris, Knox County Department of Air Pollution Control, from Jewell Harper, EPA Region IV; July 20, 1995 letter to Ron Methier, Georgia Department of Natural Resources, from Jewell Harper, EPA Region IV; Sept. 18, 1995 letter to Peter Hamlin, Iowa Department of Natural Resources, from William Spratlin, EPA Region VII.

[90] *See, e.g.*, Feb. 20, 1998 letter to James A. Joy, South Carolina Dept. of Health and Envtl. Control, from R. Douglas Neely, EPA, Air and Radiation Technology Branch.

VI. CONCLUSION

This Report shows how the industry and electric competition in Arizona has evolved from the first Electric Competition Rules in 1996, through the adoption of the current Electric Competition Rules in 1999 and the 1999 Settlement, to today's debate about wholesale competition rather than retail direct access. This evolution has apparently resulted in perceptions about the Electric Competition Rules, in both their scope and implementation, that do not fit with the historical context.

For example, given the recent debate surrounding Rule 1606(B) and the role of merchant generators who did not participate in the 1999 Settlement proceedings, it is regrettable, although perhaps understandable, that some would read a provision in Decision No. 61973 about the supply of generation during the two-year extension and expect it to reflect the current debate. When looking at the context and the comments filed by intervenors, however, it is clear that the reference was in fact focused on the supply of generation *by* APS, not *to* APS. Similarly, no one questioned that the retail Code of Conduct applied only between APS and APSES at the time it was adopted.

When viewed appropriately, and with the surrounding context, it is clear that APS' actions have been both consistent with the rules, the 1999 Settlement, and other applicable law, including each of the issues identified by the Chief Administrative Law Judge in the APS Financing Application proceeding. In fact, while APS has vigorously debated issues (as have other parties), APS has been active and responsive in implementing the policies of the Commission after the debate has concluded both with respect to the wholesale market and retail competition.

While other parties may differ with APS on the merits of its actions in requesting relief from the Commission on issues with which the Company is concerned, and while the Commission may ultimately disagree with APS on certain requests, it is not illegal to request relief. It was also not a violation of law for APS and its affiliates to pursue a business strategy designed to protect customers and shareholders and prevent what happened to investor-owned utilities in California from occurring in Arizona. That strategy has protected Arizona customers both today and into the future, has protected shareholders, and allowed the debate on electric restructuring to continue in Arizona rather than be painted as a failed experiment like in other places in the Western United States.

GLOSSARY OF TERMS

1999 Settlement - The Settlement Agreement between APS, the Commission and most of APS' customer groups that was signed on May 14, 1999 and approved with some modifications in Decision No. 61973 (October 6, 1999).

A.A.C. - Arizona Administrative Code.

AECC - Arizonans for Electric Choice and Competition.

Affiliate Interest Rules - Codified in A.A.C. R14-2-801 to -806. These state rules govern matters involving public utility holding companies.

AISA - Arizona Independent Scheduling Administrator. Required under A.A.C. R-14-2-1609(D), the AISA was designed to help provide nondiscriminatory transmission access on an interim basis until a Regional Transmission Organization became functional in Arizona.

APS - Arizona Public Service Company.

APSES - APS Energy Services is a retail Electric Service Provider as defined in A.A.C. R14-2-1601(15).

Biennial Transmission Assessment - A biennial report prepared by Commission Staff addressing the adequacy and reliability of Arizona's existing and planned transmission system.

Blue Book - A report published in 1994 by the California Public Utilities Commission setting forth a plan for retail electric competition and the restructuring of the electric industry in California.

CAISO - California Independent System Operator. An independent system operator established to provide open and non-discriminatory electric transmission services in California.

California Power Exchange - A now-bankrupt California power auction forum established to facilitate wholesale energy trades.

CC&N - Certificate of Convenience and Necessity. A certificate issued by the Commission granting a utility exclusive rights to provide services in its "service territory."

CDWR - California Department of Water Resources. The agency in California that took over power procurement on behalf of investor-owned electric utilities in 2001.

Code of Conduct - A Commission-approved code required by A.A.C. R14-2-1616. It currently applies to conduct between an Affected Utility like APS and its Competitive Retail Electric Affiliates, which for ASP is APSES. FERC also has a Code of Conduct requirement.

Commission - The Arizona Corporation Commission.

Company - Arizona Public Service Company.

Consumer Information Label - A label provided to customers on request and discussed in A.A.C. Rule R14-2-1617 that outlines a variety of information about Standard Offer and competitive electric service.

DASR - Direct Access Service Request. An electronic form used to communicate between UDCs and ESPs.

Desert STAR - Desert Southwest Transmission and Reliability Operator. The predecessor of WestConnect. Desert STAR was a product of the initial effort to develop an independent system operator or regional transmission organization in Arizona.

Electric Competition Rules - A.A.C. R14-2-1601 to -1617.

Environmental Portfolio Standard - A renewable resources portfolio program that is codified at A.A.C. R14-2-1618.

EPA - The United States Environmental Protection Agency.

ESP - Electric Service Provider. Under the Electric Competition Rules, ESPs obtain competitive CC&Ns and provide Competitive Services to retail customers under bilateral or multilateral contracts.

FCCR - Fixed Charge Coverage Ratio. A ratio used by financial analysts in determining the creditworthiness of a company.

FERC - The Federal Energy Regulatory Commission. FERC has exclusive jurisdiction over interstate transmission and sales of power for resale.

Financing Application - The application filed by APS in Docket No. E-01345A-02-0707 and which was approved by Decision No. 65796 (April 4, 2003).

Generic Stranded Costs Order - Decision No. 60977 (June 22, 1998). Addressed stranded cost recovery for Affected Utilities.

H.B. 2663 - House Bill 2663, enacted by the Arizona Legislature in 1998 to address retail electric competition.

ISO - Independent System Operator, which is similar to an RTO.

Must-Run Generation Units - Local generation that is necessary to maintain the reliability of the electric system when external or remote generation cannot be used to meet load requirements in an area.

OASIS - Open Access Same-Time Information System. Instituted by FERC Order 889, an OASIS provides real-time information to transmission users.

OATT - Open Access Transmission Tariff. The OATT is the tariff required by FERC Order 888, to implement wholesale open access.

Pinnacle West - Pinnacle West Capital Corporation, the holding company and parent entity of APS, APSES and PWEC.

PWEC - Pinnacle West Energy Corporation, the wholesale generation affiliate of APS and a subsidiary of Pinnacle West.

Request for Partial Variance - The application filed by APS in October 2001 pursuant to A.A.C. R14-2-1614 in Docket No. E-01345A-01-0822. The Commission stayed this application in Track A.

RTO - Regional Transmission Organization. An RTO is discussed in FERC Order 2000 and FERC's Standard Market Design initiative. It is intended to provide for regional operation and development of transmission systems to facilitate wholesale competition.

RUCO - The Residential Utility Consumers Office.

Schedule 10 - Implements APS' rules and regulations for direct access service, as well as addressing the business relationship between APS and Electric Service Providers offering service in APS' distribution service area.

SIC - System Incremental Costs.

SMA - Supply Margin Assessment. An interim method being used by FERC to evaluate whether an owner of generation has market power in a given market.

SRSG - Southwest Reserve Sharing Group. An organization established to allow sharing of contingency reserves among participants to realize more efficient and economic power system operations while maintaining the reliability of the interconnected system.

SSG-WI - Seams Steering Group-Western Interconnection. This group is addressing seams and interface issues amongst the three Western United States RTOs—WestConnect, the CAISO, and RTO West.

Standard Offer Customers - Customers who continue to purchase electric generation from an incumbent utility.

TEP - Tucson Electric Power Company.

Track A - The proceeding resulting from the Generic Investigation into the Electric Competition Rules in Docket No. E-00000A-02-0051.

Track A Decision - Decision No. 65154 (September 10, 2002).

Track B - The proceeding addressing competitive solicitations by APS and TEP in Docket No. E-00000A-02-0051, *et al.*

Track B Decision - Decision No. 65743 (March 14, 2003).

TTC - Total Transfer Capability. This is the amount of capacity available on a transmission line.

UDC - Utility Distribution Company. Under the Electric Competition Rules, a UDC was to provide Standard Offer service and unbundled distribution service to customers, but would not own any generation.

WAPA - Western Area Power Administration. One of several federal agencies tasked with the responsibility of marketing electricity generated by facilities owned and operated by the federal government.

WECC - Western Electricity Coordinating Council. Formed in April 2002 by the merger of the Western Systems Coordinating Council, the Southwest Regional Transmission Association and the Western Regional Transmission Association, the WECC is responsible for coordinating and promoting electric system reliability for the Western United States' power grid.

WestConnect - An RTO that is being developed for Arizona and the Southwest.

WSCC - Western Systems Coordinating Council. The WSCC was the precursor to the WECC.

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